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AIDING RURAL ECONOMIES

A National Survey of Business Lending with State Community Development Block Grant Funds

Council of State Community Affairs Agencies

COSCAA

AIDING RURAL ECONOMIES:
A NATIONAL SURVEY OF BUSINESS LENDING WITH STATE CDBG FUNDS

A Report Prepared for the
Council of State Community Affairs Agencies by

Beth Siegel and Peter Kwass

Mt. Auburn Associates
408 Highland Street
Somerville, MA 02144

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I. INTRODUCTION

Purpose of Study

The U.S. Department of Housing and Urban Development's Community Development Block Grant (CDBG) Program has become a major source of public dollars for economic development financing in rural communities in recent years. A recent study on state distribution of Small Cities CDBG funding (for communities of 50,000 or less), conducted by the Council of State Community Affairs Agencies (COSCAA), found that about $517 million in Small Cities CDBG financing was used for business lending between 1982 and 1986. This constituted 64 percent of CDBG funds spent on economic development projects. Moreover, over 70 percent of Small Cities CDBG business loans between 1982 and 1986 were made to businesses in rural (non-metropolitan) counties.

In light of its heavy use in rural communities, CDBG business financing has the potential to effect significantly rural economic development. Because CDBG funds are provided to states as grants, states have great flexibility to structure CDBG business financings to stimulate business development. CDBG financings can be offered as loans at very low rates or can be structured as equity or equity-like investments. The program has been used by states to support the full range of business development activities – from providing capital subsidies to attract branch plants to offering access to capital for startups, expanding firms, or mature firms in need of financial restructuring. CDBG business financing can also play an important role in creating economic opportunities for the rural poor since HUD requires that at least 51 percent of jobs created or retained through a CDBG financing be provided to members of low- and moderate-income households.

While the CDBG Program has great potential to affect rural economic development, no systematic efforts had been made until recently to compile and evaluate nationwide information on its impacts. Then, in 1988, the Council of State Community Affairs Agencies received funding from the Ford Foundation Rural Poverty and Resources Program and the Rural Economic Policy Program of the Aspen Institute to conduct a major study of the use of CDBG funds for rural economic development. This report provides a portion of the findings of that study.

The overall purpose of the study was to examine the state CDBG Program's role in rural economic development from three perspectives:

- the *magnitude* of expenditures on rural economic development activities, including the types and locations of projects funded;
- the *impact* of project expenditures on job generation in rural areas;
- the *influence* of CDBG expenditures on other state rural economic development efforts.

By focusing on these three areas, the study is intended to provide an in-depth look at how the CDBG Program has been used for rural economic development, and to provide useful insights for other state rural economic development efforts.

The study has three components. One component is a state-by-state survey which obtained information on overall CDBG expenditures for economic development, and on individual business loans and other economic development projects. The survey data was used to document the magnitude of CDBG economic development activities, and develop a profile of the characteristics of projects (e.g., type, size), firms, (e.g., sector, stage of development, size), and communities (e.g., economic, demographic conditions) which received CDBG economic development funding.

A second component of the study is a series of case studies of the rural economic development policies and programs of eight states. The purpose of the case studies is to develop a more in-depth understanding of state institutional arrangements and strategies for rural development.

A third component of the study, the results of which are presented in this report, is a survey of a sample of businesses which received financing

through state CDBG funds. The purpose of the borrower survey was threefold:

- First, to develop a better understanding of how the CDBG Program is being used for business lending, and in particular to supplement the data provided by state CDBG Program administrators. Additional borrower information provided through the survey includes the borrower's financial condition at time of loan, and firm ownership characteristics.

- Second, to document the kinds of impacts CDBG loans have on rural economic conditions. This involved obtaining information on the impacts of CDBG financing on the borrower's investment and hiring decisions, the extent to which CDBG funds are complementing or substituting for private financial institutions, the quality of the jobs created, the proportion of jobs that go to the rural poor, and the proportion of borrowers that remain in business.

- Third, to develop insights into the conditions under which CDBG business financing can have the most impact on rural economies. This involves comparing the differential impact of loans to different types of borrowers and communities.

It is hoped that the results of this component of the study, both in itself and along with the study's other components, will provide policymakers with both an expanded knowledge of the various options for rural economic development and a better understanding of how resources for rural business financing and other economic development tools can be used most effectively to stimulate investment and job generation in rural communities.

Current State Uses of CDBG Funds for Business Financing—an Overview

In 1981, Congress gave states the option of administering the non-entitlement portion of the CDBG Program through the Omnibus Budget Reconciliation Act of 1981. This act also made direct assistance to for-profit businesses an eligible activity for CDBG funding. In exchange for creating or retaining jobs for low- and moderate-income individuals, CDBG funds could be provided to meet the capital needs of private businesses.

Direct assistance to for-profit firms has become the largest use of CDBG funds for economic development activity, followed by the construction of infrastructure to support business development. Direct assistance usually involves loans, loan guarantees, interest write downs, lease purchase agreements, or some other form of capital infusion. Typically, the state makes a grant to a local government which then loans the money to an identified business. The state determines that the project meets certain conditions, normally that: 1) the project provides at least 51 percent of its jobs to low- and moderate-income individuals or meets another urgent national need (as defined in the CDBG legislation); and 2) capital be provided only when "necessary or appropriate," that is, in circumstances and under conditions that preclude its availability at a reasonable cost through more traditional channels. Often, the local government administers the loans and may, under certain circumstances, exercise the option of receiving the loan paybacks and applying those funds to similar activities in the future. Virtually every state allows grantees to submit applications for this type of assistance. In FY 1987, lending to for-profit firms was the most common categorical set aside among the 30 states with economic development set-asides.

The Council of State Community Affairs Agencies (COSCAA) study on how states have used their CDBG allocation for business lending and other economic development activities found that economic development projects represented approximately 17 percent or $800 million of the $4.5 billion of CDBG funds available between 1982-86. Of these dollars, over $.5 billion were used for loans to for-profit firms. Loan assistance, as both a part of CDBG and economic development expenditures, has increased from 4.5 percent of all CDBG expenditures in 1982 to 15 percent in 1986. This same trend applies to loans as a percentage of economic development expenditures. Loans increased from 39 percent of all economic develop-

ment expenditures in 1982 to 72 percent in 1986 (see Chart 1.1).

The use by state governments of Community Development Block Grant funding for business financing reflects a growing trend in economic development efforts targeted to the economically disadvantaged. Policymakers have recognized that assistance to the economically disadvantaged must go beyond a social infrastructure and human resource development approach to include direct job creation. Financing programs can play an important role in the process of job creation. They can compensate for the increased cost and risk for firms located in distressed communities or hiring a high proportion of economically disadvantaged workers, and they can provide access to financing for economically disadvantaged entrepreneurs, helping to create not only jobs but a local entrepreneurial base. More generally, financing programs can help stem the outflow of capital from distressed communities, particularly when they are designed to encourage participation in the economic development process by private financial institutions. As part of a comprehensive strategy to address barriers to employment and empowerment among the economically disadvantaged, financing programs can thus play a significant role in efforts to eliminate urban and rural poverty.

Summary of Methodology

Five specific research questions were developed to be answered with information obtained through a survey of borrowers of the CDBG Program and data collected from states on the characteristics of financings, borrowers, and communities in which financings are made. These questions were:

1) What are the characteristics of borrowers being served by the CDBG Program?

2) What are the characteristics of the financings being provided?

3) What are the characteristics of communities in which financings are made?

4) What are the impacts of CDBG financing on rural economies?

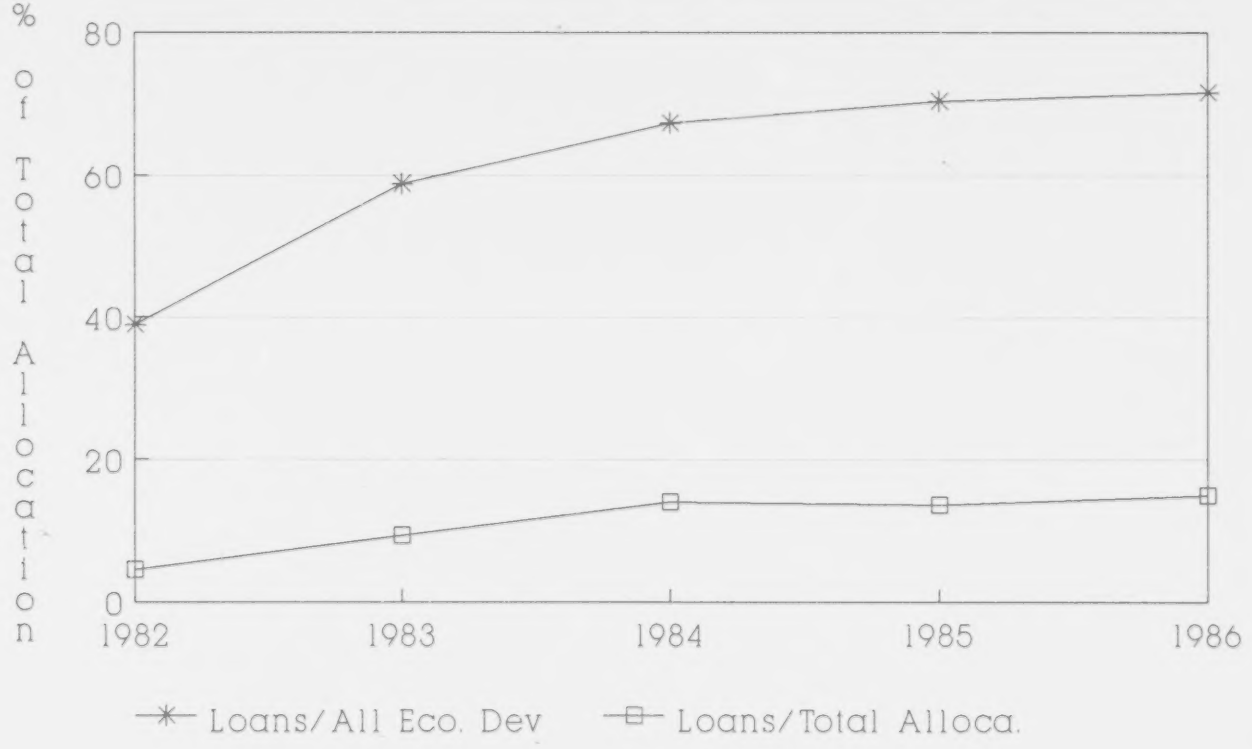
5) How have the impacts of CDBG financings differed in different types of communities and among different types of borrowers?

Because the primary mission of the CDBG Program is to promote local job creation and retention, particularly for the economically disadvantaged, it was decided that the jobs created and retained as a result of CDBG financings would be the central program impact to be measured. Measurement of job creation and retention involves two dimensions: *quantity* – the number of new or saved jobs, measured in relation to the dollar amount of CDBG financing; and *quality* – wage levels, working conditions, and advancement opportunities. In measuring the job creation or retention impacts of CDBG financings, emphasis was placed on measuring the importance of CDBG financing to the borrower's investment decision. The degree to which CDBG financing does or does not substitute for financing available in the private market can seriously alter estimates of job creation and retention impact. Consequently, care was taken to find ways to estimate the likelihood that the business investment would not have taken place without the availability of CDBG funds, i.e., the likelihood that the CDBG financing did not substitute for private sources of capital.

Data for the statistical analysis were obtained from three sources: 1) a telephone survey of a sample of CDBG borrowers; 2) loan data obtained from a survey of state CDBG administrators; 3) economic and demographic data for each county in which loans were made. The period January 1, 1983 to December 31, 1985 was chosen as the time frame for the study because it would permit estimates of employment impacts over a two-year period for all financings being studied, but would also entail analysis of fairly recent experience, making accurate responses to survey questions more likely. The borrower sample consisted of 715 borrowers who received loans from the CDBG Program during the study timeframe. This sample size was chosen in order to obtain approximately 400 completed surveys based on response rates obtained from similar surveys. The borrower survey was administered by telephone.

A more detailed description of the methodology is attached as an Appendix.

CHART 1.1
CDBG BUSINESS LENDING BY STATES



II. PROFILE OF CDBG BUSINESS LOANS

Profile of Borrowers

Information from the survey of states and from the survey of business borrowers provides a profile of the type of firms receiving CDBG loans. The following data were collected from these sources:

- *Survey of States*: The survey of state CDBG programs provided information on a total of 2,317 borrowers who received financing between January 1, 1982 and December 31, 1986. Information related to the type of business activity financed, the industry of the borrower, ownership characteristics of the firm and the size of the borrower was provided by the states.

- *Survey of Borrowers:* The telephone survey of borrowers provided information on 401 companies which received financing between January 1, 1983 and December 31, 1985. Two hundred ninety-nine of these were still in business in the communities through which the states provided the CDBG financing, 99 had gone out of business, and three had moved. Borrowers provided information on the goods and services they produced, their financial condition prior to financing, the number of years they were in business, their ownership characteristics, and their current number of employees.

Analysis of State Surveys

States have used the CDBG Program to finance a wide range of business activities. The range of activities funded through the CDBG Program fall into the following categories:

1. *Startup*: The firm benefiting from the CDBG funds had started its operations within two years of the time of the CDBG investment.

2. *Branch Plant*: The firm benefiting from the CDBG funds was establishing a new branch plant or subsidiary in the community receiving the CDBG funds. The parent firm could be either located in or outside of the state.

3. *Expansion*: The firm benefiting from the CDBG funds was adding capacity at an existing site.

4. *Retention*: The firm which received the CDBG funds was an existing plant which was in danger of closing without the CDBG investment.

5. *Intrastate Relocation*: The firm benefiting from the CDBG investment relocated all or part of its activities from one part of the state to another.

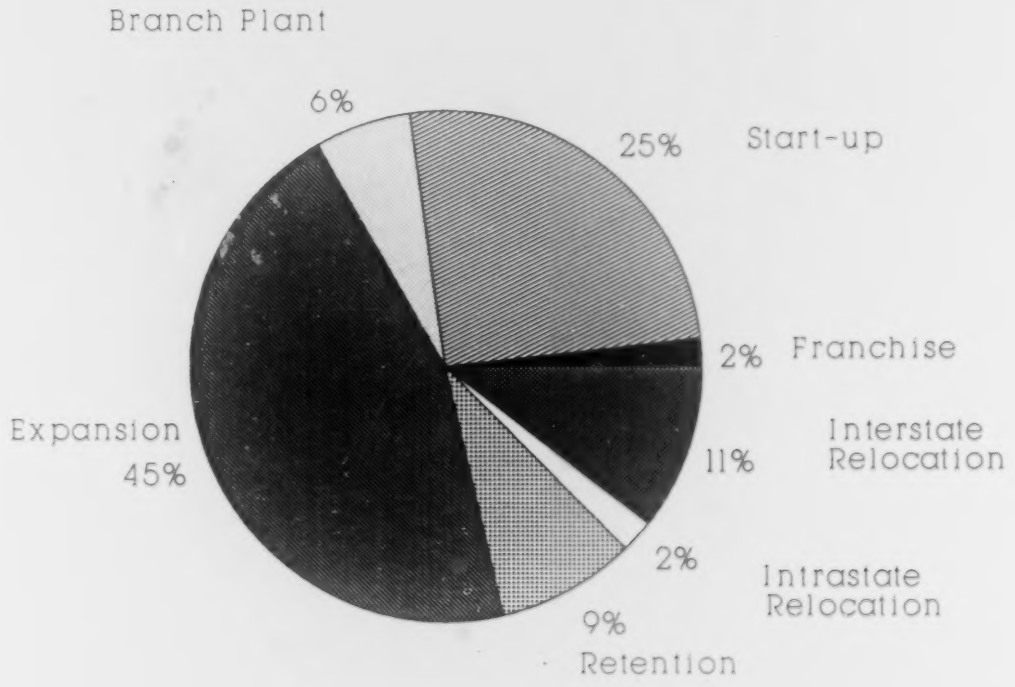
6. *Interstate Relocation:* The firm benefiting from the CDBG investment relocated all or part of its activities from another state.

7. *Franchise*: The firm which received the CDBG funds operated under an arrangement with an organization which had developed a successful retail product or service and granted the firm the right to engage in the business for a fee.

The most common type of situation supported through the CDBG Program is the expansion of an existing firm at its current site. Over 45 percent of the CDBG economic development projects and about 39 percent of the CDBG funds went to firms fitting this description. Funding for startup firms was the second most common kind of economic development activity funded – accounting for about 25 percent of the projects and 22 percent of the CDBG funds. Relocations, both interstate and intrastate, and branch plants, accounted for 19 percent of projects and 25 percent CDBG funding. The proportion of funds used for this purpose provides evidence that states and localities utilize the CDBG Program as one of their incentives to recruit companies to their communities (See Chart 2.1).

While information was collected on the ownership characteristics, size, and industry of firms which received assistance from states through the CDBG Program, many states do not keep information on these characteristics. As a result, there is

CHART 2.1
TYPE OF BUSINESS LOAN PROJECT



more limited information available on the characteristics of firms which have been assisted through the CDBG Program.

With respect to ownership characteristics, information was made available on 895 of the 2,317 businesses which received CDBG funds during the period being studied. Of these companies, 6.3 percent were owned by minorities and 5.8 percent were owned by women. The size of the CDBG investment in minority and women-owned firms was smaller than the average, particularly in the case of women-owned firms. While 5.8 percent of the projects went to women-owned firms, only 2.6 percent of the CDBG funds for business loan projects went to firms which were owned by women.

Information on the size of the firm receiving assistance was available for a relatively small proportion of the business loan projects (943 projects). However, the data available provides strong evidence that the vast majority of companies benefiting from the CDBG Program are very small. Over 69 percent of the CDBG business loans went to private businesses which had 25 or fewer employees and about 88 percent went to firms with under 100 employees. Larger companies clearly received a larger average amount of CDBG assistance. As a result, when looked at in terms of funds lent, larger firms had a more significant proportion. For example, firms with over 100 employees accounted for only 12.5 percent of the projects, but 23.2 percent of the CDBG funds lent to businesses.

Given the interest of states in using CDBG funds for economic development activities which generate good jobs in their communities, it is not surprising that the majority of projects and funds went to businesses which were in the manufacturing sector. About 68 percent of all of the firms receiving CDBG funds were involved in manufacturing. Moreover, since the average size of the CDBG project was much larger for manufacturing projects, a total of about 79 percent of all of the CDBG funds going to private businesses during the 1982 to 1986 period went to companies in the manufacturing sector (see Chart 2.2).

Information on the more specific industrial composition of firms receiving CDBG assistance was also gathered. Within manufacturing there seemed to be a large proportion of firms in natural resource-based industries. For example 6.9 percent of the firms were involved in the food industry and 7.2 percent were involved in lumber and wood products. There was also a large number of companies involved in the metalworking industry with 7.2 percent of the companies involved in the manufacture of fabricated metal products and 8.2 percent in non-electrical machinery. A small proportion of companies were in the high growth electronics and instrumentation fields (see Table 2.1).

Firms in the retail trades, particularly restaurants (4.3 percent of all firms) and food stores (2.3 percent of all firms), were the most common types of service companies receiving CDBG assistance. Close to 12 percent of the firms receiving CDBG funds were involved in retail activities. Firms in other service industries were not highly represented. Only about 2.6 percent of the companies were in wholesale trades, 1.8 percent in business services, and 1.8 percent in finance, insurance or real estate.

Analysis of Business Survey

The telephone survey of borrowers included some of the same information that was provided by the states, the difference being that the information was provided by the borrowers themselves. Thus information on borrower industry, size at the time of financing and stage of development are the borrowers' own characterization of their firms.

With respect to how businesses characterized their stage of development, the majority of borrowers were established firms at the time the CDBG financing was provided. Since CDBG financing is supposed to provide financing to firms unable to access conventional sources, it is not surprising that most of these established firms had variable profitability or were experiencing operating losses. About 24 percent of the firms considered themselves to be established companies with healthy profits. These firms were the least likely to need CDBG financing (see Chart 2.3).

Startup firms were also a high percentage of CDBG borrowers at the time the CDBG financing was provided. Almost four in ten respondents to the borrower survey reported that they were startup

Chart 2.2
INDUSTRY OF BORROWER

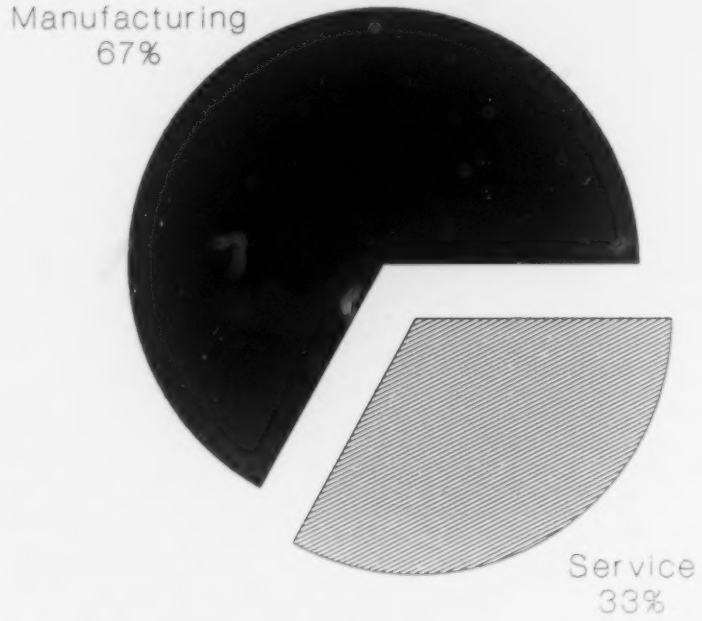


TABLE 2.1

BUSINESS LOAN PROJECTS
BY INDUSTRY
(N = 1523)

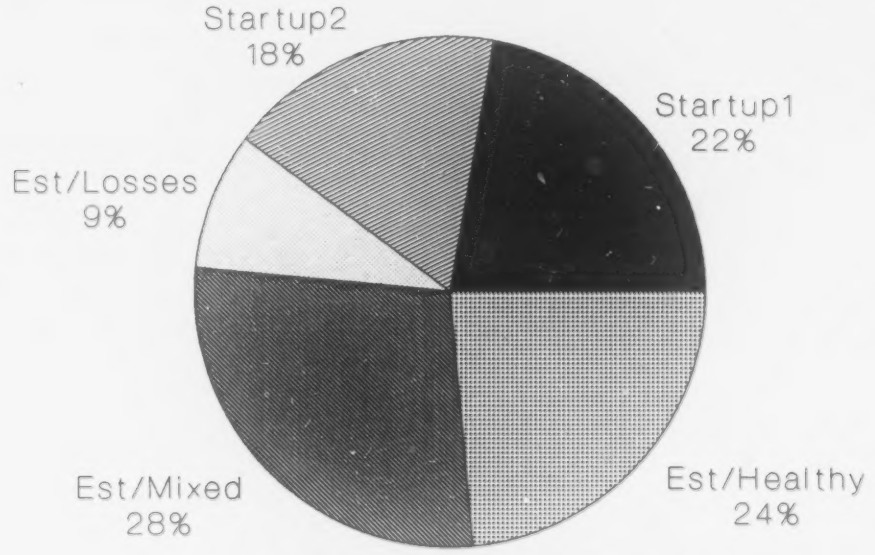
	METRO	NON-METRO	ALL PROJECTS
MINING	.5%	.9%	.8%
CONSTRUCTION	2.7%	2.3%	2.4%
MANUFACTURING			68.3%
FOOD AND KINDRED PRODUCTS	5.8%	7.1%	6.9%
TEXTILE MILL PRODUCTS	2.9%	1.8%	2.1%
APPAREL AND OTHER TEXTILE PRODUCTS	2.2%	4.3%	3.9%
LUMBER AND WOOD PRODUCTS	4.1%	8.3%	7.2%
FURNITURE AND FIXTURES	4.1%	4.6%	4.5%
PAPRE AND ALLIED PRODUCTS	3.2%	1.1%	1.6%
PRINTING AND PUBLISHING	1.5%	1.7%	1.6%
CHEMICALS AND ALLIED PRODUCTS	.7%	2.4%	1.9%
PETROLEUM AND COAL PRODUCTS	.5%	0.0%	.1%
RUBBER AND MISC. PLASTICS	6.1%	3.6%	4.3%
LEATHER AND LEATHER PRODUCTS	1.2%	.6%	.8%
STONE, CLAY, AND GLASS PRODUCTS	2.2%	2.0%	2.0%

TABLE 2.1
(Continued)

	METRO	NON-METRO	ALL PROJECTS
PRIMARY METAL INDUSTRIES	2.4%	3.0%	1.9%
FABRICATED METAL PRODUCTS	8.3%	6.8%	7.2%
MACHINERY, EXCLUDING ELECTRICAL	10.2%	7.5%	8.2%
ELECTRIC AND ELECTRONIC EQUIFMENT	5.6%	5.0%	5.2%
TRANSPORTATION EQUIPMENT	3.4%	5.3%	4.8%
INSTRUMENT AND RELATED PRODUCTS	2.4%	1.3%	1.6%
MISC. MACHINERY	1.9%	2.3%	2.2%
TRANSPORTATION, COMMUNICATION, UTILITIES	2.7%	3.0%	3.0%
WHOLESALE TRADE	1.7%	3.0%	2.6%
RETAIL TRADE-TOTAL	11.2%	11.7%	11.6%
Food Stores	1.7%	2.4%	2.3%
Restaurants	3.9%	4.4%	4.3%
FINANCE, INSURANCE, AND REAL ESTATE	3.4%	1.2%	1.8%
SERVICES	6.1%	7.0%	6.7%
Hotesl	1.2%	2.0%	1.8%
Business Services	3.2%	1.3%	1.8%

*NOTE: DOES NOT TOTAL 100% BECAUSE OF MISSING SIC CODES.

CHART 2.3
FINANCIAL CONDITION
PRIOR TO CDBG FINANCING



Est=Established Companies
Startup1=Profitable after 2 years
Startup2=profitable before 2 years

firms. Of these, about 22 percent had not expected to be profitable within their first two years when the financing was provided, while 18 percent had expected to be profitable within that time period.

Curiously, the age of the borrowing firms, as reported by the borrowers, is not entirely consistent with the borrowers' own characterization of their stage of development. While about 40 percent of respondents characterized themselves as startups, less than 20 percent indicated that they were less than five years old at the time of the CDBG financing. The data on firm age appear more consistent with the information on business type obtained from the state survey, which indicated that about 25 percent of the borrowers were startups. This inconsistency may result from firms characterizing themselves as startups if they were branch plants or subsidiaries of existing companies establishing new facilities.

The great majority of survey respondents, almost four out of five, were independent and locally-owned companies. A little less than one out of five were branches of subsidiaries of firms headquartered elsewhere. A very small fraction were franchise operations (see Chart 2.4).

The borrower survey confirmed that the vast majority of firms financed with state CDBG funds are very small. Over half of the companies in the survey – 51 percent – had under ten employees at the time of the financing, and 65 percent had less than 20 employees. Only 10 percent of the firms surveyed had one hundred or more employees (see Chart 2.5).

The borrower survey also confirmed the emphasis of the state CDBG Program on financing firms in the manufacturing sector. According to the firms' own definitions of the goods and services they provided, about 67 percent were manufacturing concerns.

Summary

Based on an analysis of borrower characteristics both from the state survey and the borrower survey it is clear that for the most part the CDBG Program is being used to finance small to medium-sized manufacturing facilities – the types of enterprises which are important to local economic development. The size and financial condition of the firms being financed provide evidence that CDBG funds are also being used to assist the types of firms most likely to have difficulty in accessing conventional sources of financing. Studies of financing for small businesses have found evidence that very small businesses and startup businesses face barriers in accessing bank financing. Moreover, firms with mixed profitability and those with operating losses are often perceived as too high a risk by conventional lenders.

Characteristics of CDBG Financing and Technical Assistance

The survey of states and the telephone survey of borrowers provided a range of information on the characteristics of the loans being made through the CDBG Program as well as the other services being provided or leveraged through the program:

- *State Survey*: The states provided information on the lending terms for each of the loans made. The terms included: interest rate, the maturity of the loan, what the financing was used for, whether the loan was subordinated, other public and private sector financing which was involved in the project, and whether or not any type of principal or interest and principal deferral were provided to the borrower.

- *Borrower Survey:* The survey of borrowers provided additional information on the types of financing provided. More importantly, the business survey provided information on other services provided by the organizations providing the CDBG financing – general management assistance and loan packaging assistance.

Analysis of the State Surveys

The average size of the loans made to businesses through the state CDBG Program is relatively large – approximately $216,000. While the high average size of the loans is somewhat surprising in light of the small size of the companies receiving

CHART 2.4

CHARACTERISTICS OF BUSINESS OWNERS

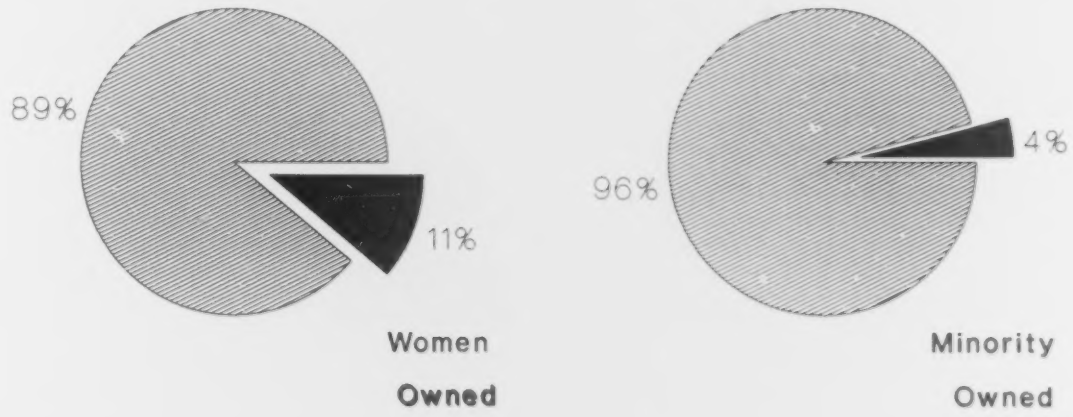
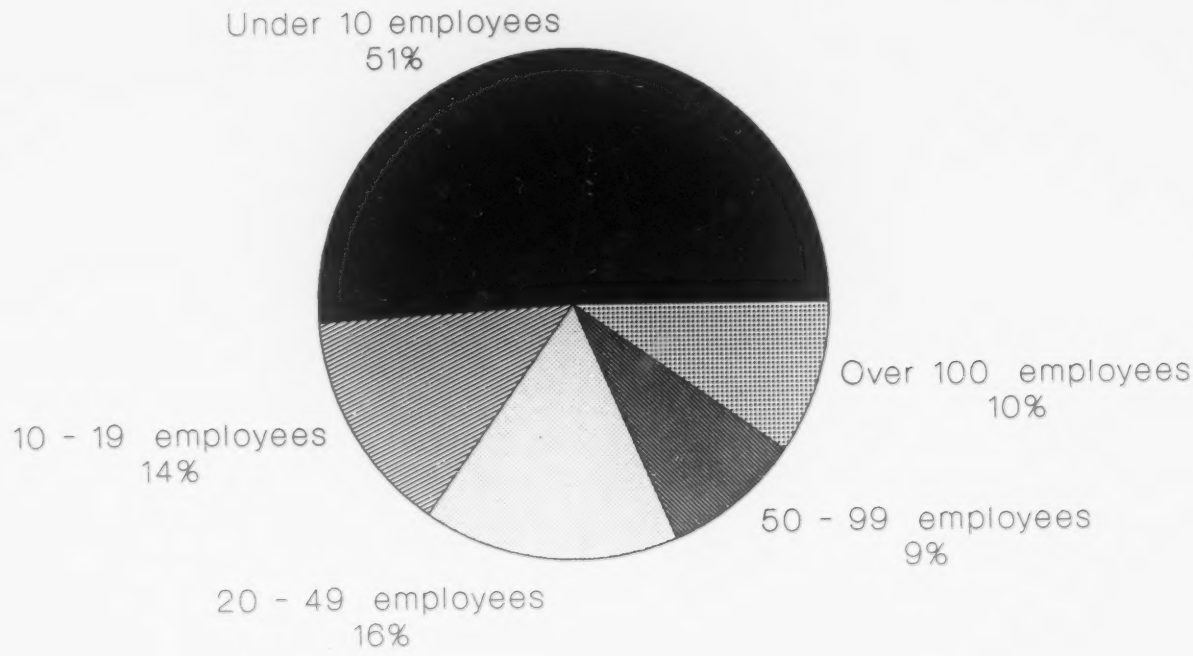


CHART 2.5

SIZE OF BUSINESS



financing through the CDBG Program, it reflects the use of CDBG funds for fixed asset financing rather than for working capital.

Aside from franchises, which were a very small proportion of the projects financed, the largest average loan was provided to branch plant projects. The lowest amount was provided to startups and expansions. This indicates that the larger projects assisted through CDBG funds tend to be branch plants of large manufacturing concerns rather than locally-owned firms (see Chart 2.6).

Most CDBG loans are provided on very favorable terms. An overwhelming proportion of the loans to survey respondents (90 percent) were provided at fixed interest rates. *Fixed-rate financing* is increasingly difficult to obtain at reasonable rates in the private financial market, particularly for smaller firms. Larger companies have access to sources of fixed-rate, long-term funds that typical small businesses do not, such as the corporate bond market and the life insurance industry. Yet, long-term, fixed-rate financing is as important to smaller firms as it is to large companies. A fixed interest rate reduces the variability of the borrower's net cash flow, allowing the borrower to plan its operations with greater confidence (see Table 2.2).

Sixty-five percent of loans were provided on a subordinated basis. *Subordinated financing,* which is important for small, growing businesses, is also difficult to obtain in the private market. Most commercial banks, which are the primary source of financing for small businesses, look to protect their position fully with collateral when they make loans. If, as part of a total financing package, a public-sector lender is willing to take a subordinated position, a private-sector lender will have greater protection and be more likely to make the loan. Without the subordination, the borrower would not be able to obtain as large an amount of financing, if any (see Table 2.2).

Close to one-third of CDBG loans were provided with *principal deferrals* and about one-fifth were provided with interest deferrals (see Table 2.2). Principal and interest deferrals reduce cash outflows from debt service during the initial time period of the loan. This can be very useful for startup firms that often begin their operations in the red. It is, in effect, a form of equity-like financing during the time that the deferrals are in effect.

On average, the *maturity* of CDBG loans was about 11 years. This high average maturity indicates that the CDBG Program is providing loans for much longer terms than conventional lenders. Longer maturities reduce the borrower's monthly debt service, thus leaving more cash on hand to meet operating expenses. This is an important benefit for an expanding or restructuring firm.

In addition to the preferential financing features mentioned, borrowers also received substantial interest rate subsidies through the State CDBG Program. The average interest rate charged to borrowers was 5 percent in 1983, 6 percent in 1984, and 6 percent in 1985. In comparison, the average prime rate charged by banks during this period was: 10.79 percent in 1983, 12 percent in 1984 and 9.9 percent in 1985. Given that small business borrowers are usually charged interest rates above the prime rate for commercial and industrial loans, the average subsidy provided through the CDBG Program ranged between five and six percentage points.

With respect to the impact of CDBG loans on leveraging private investment, data from the state survey indicate that CDBG loans leveraged $3.80 in private dollars for every CDBG dollar lent. It should be noted that leveraging data must be viewed with caution when other public investments are involved in a business financing since it cannot be determined with certainty which source of public dollars was most critical in leveraging private funds. In the case of CDBG loans, on average $.80 from other public financing sources was invested in CDBG projects for every $1.00 in CDBG funds invested. While this makes it difficult to attribute all private investment to the CDBG investment, it is noteworthy that, on average, the CDBG Program was the largest public investor in these projects. Discussion of leveraging must also take into account the extent to which CDBG dollars are substituting for private financing. If a CDBG borrower can obtain financing elsewhere, the private participation in a CDBG financing cannot truly be considered attributable to the CDBG involvement. Thus, to the extent that substitution is occurring, the degree of leveraging is less than the above figures suggest. A

CHART 2.6
AVERAGE SIZE
CDBG LOAN BY TYPE OF PROJECT

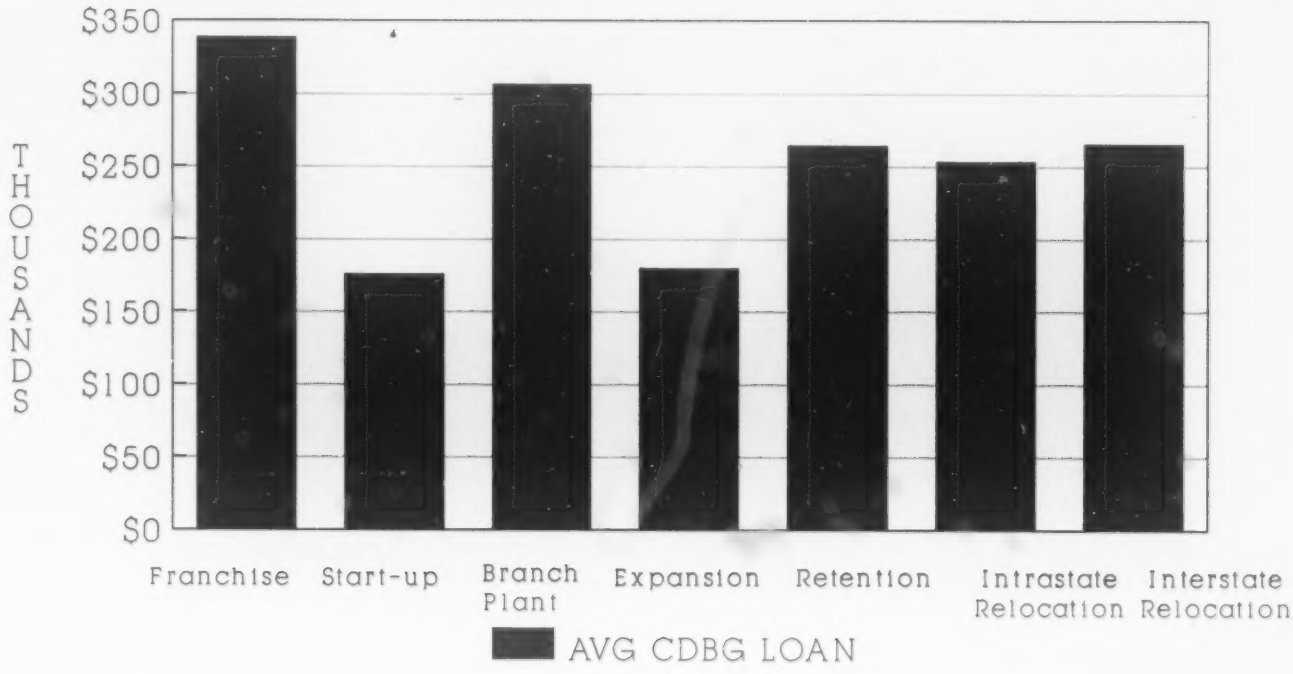


TABLE 2.2

CHARACTERISTICS OF THE FINANCING

	ALL BORROWERS	RURAL BORROWERS	METRO BORROWERS
Average Size Loan (N = 2,257)	$216,570	$215,657	$220,748
Average Term	11 years	11 years	11 years
Percentage of Loans With Fixed Interest Rates	90.2%	91.3%	87.5%
Percentage of Loans Subordinated	64.8%	61.5%	74.5%
Percentage of Borrowers Receiving Principle Deferral	30.7%	32.1%	26.5%
Percentage of Borrowers Receiving Interest Deferrals	20.0%	21.4%	16.3%

discussion of the extent of substitution of CDBG financing occurs later in this report.

Analysis of the Business Survey

According to borrowers, the great majority of CDBG loans are used for the purchase of fixed assets. About 51 percent of the projects involved the acquisition, expansion, or modernization of a building and close to 60 percent involved some form of financing for equipment. Only 16.4 percent of the projects involved financing for operating capital (see Chart 2.7). With respect to loan size, most loans, about 80 percent, were for $50,000 or more, and almost two-thirds, were for amounts of $100,000 or more.

While organizations providing CDBG financing to businesses offer very preferential terms with respect to the maturing of the loan, deferrals of principal and interest, and subordination, it is the lower interest rate which is the most important feature of the CDBG financing to most borrowers. In fact, almost all of the borrowers ranked lower interest rates as either the most important or the second most important feature of CDBG financing. The second most important feature of the financing according to borrowers was simply access to financing where none was otherwise available. Other financing terms such as subordination, deferrals, longer terms, and fixed rates were not considered very important to the vast majority of borrowers (see Chart 2.8).

A very small proportion of the borrowers financed through the CDBG Program received any form of management assistance, though about 40 percent did receive some assistance in financial packaging. Clearly, management assistance has not been emphasized as part of efforts to promote busi-

CHART 2.7

SIZE OF CDBG LOANS

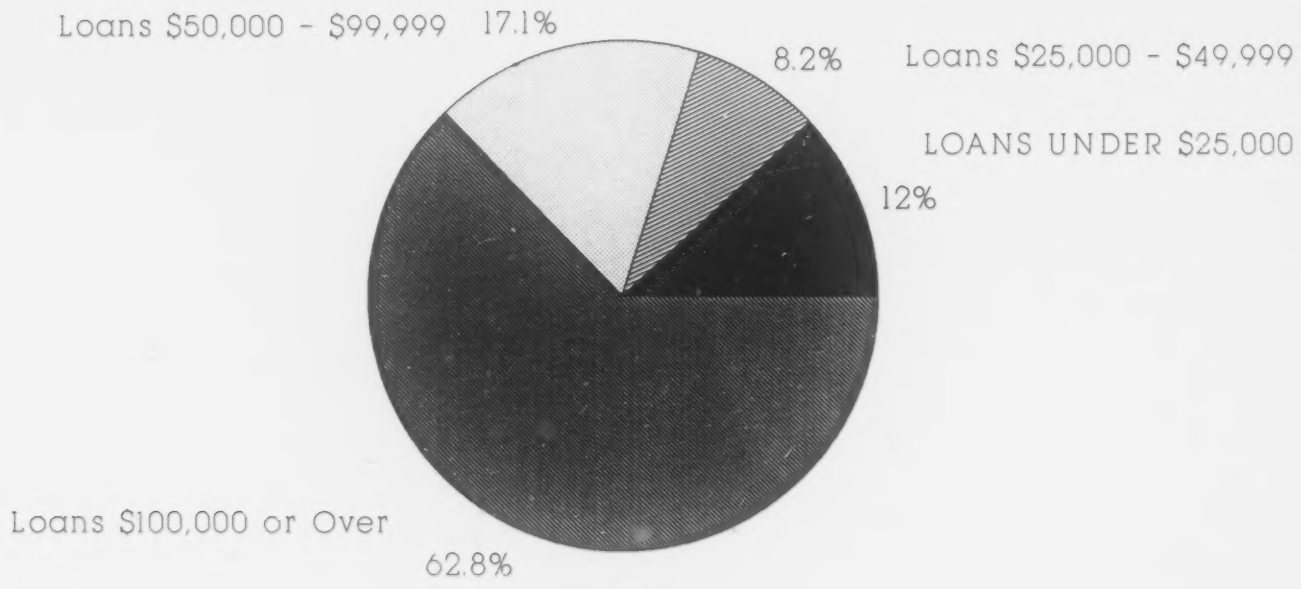
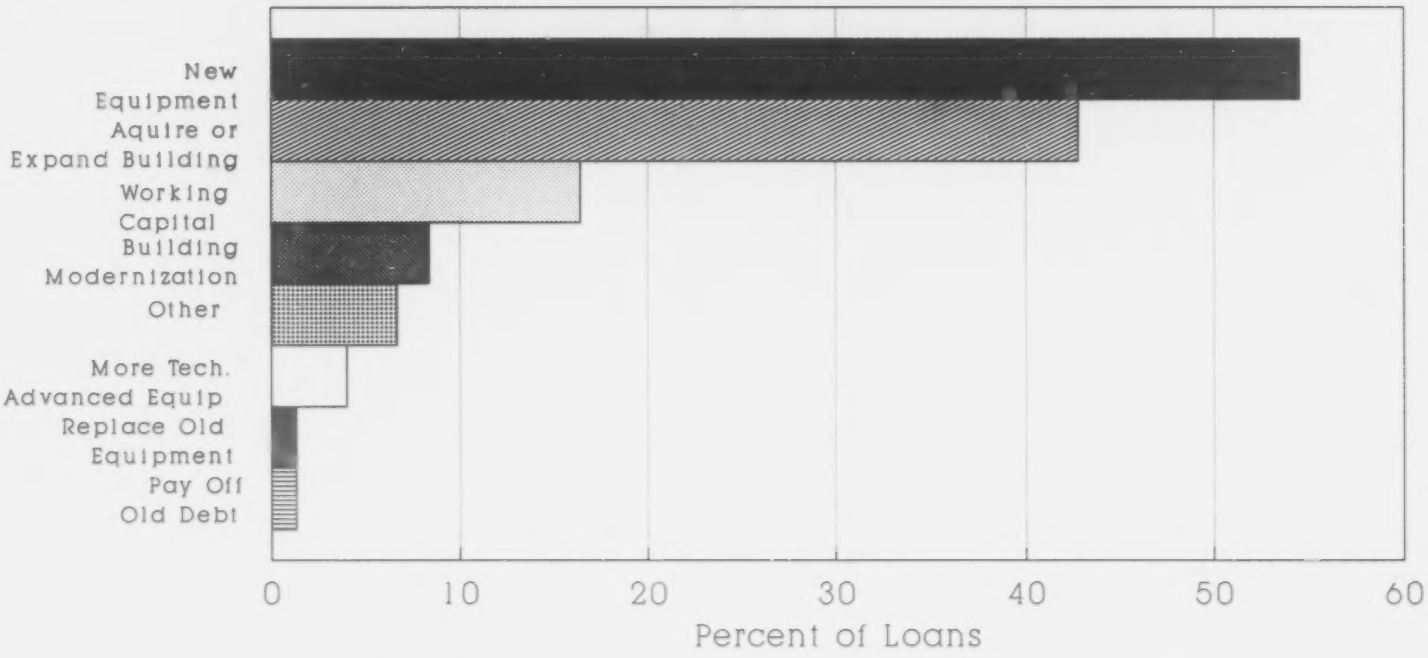


CHART 2.8
WHAT CDBG FINANCING WAS USED FOR



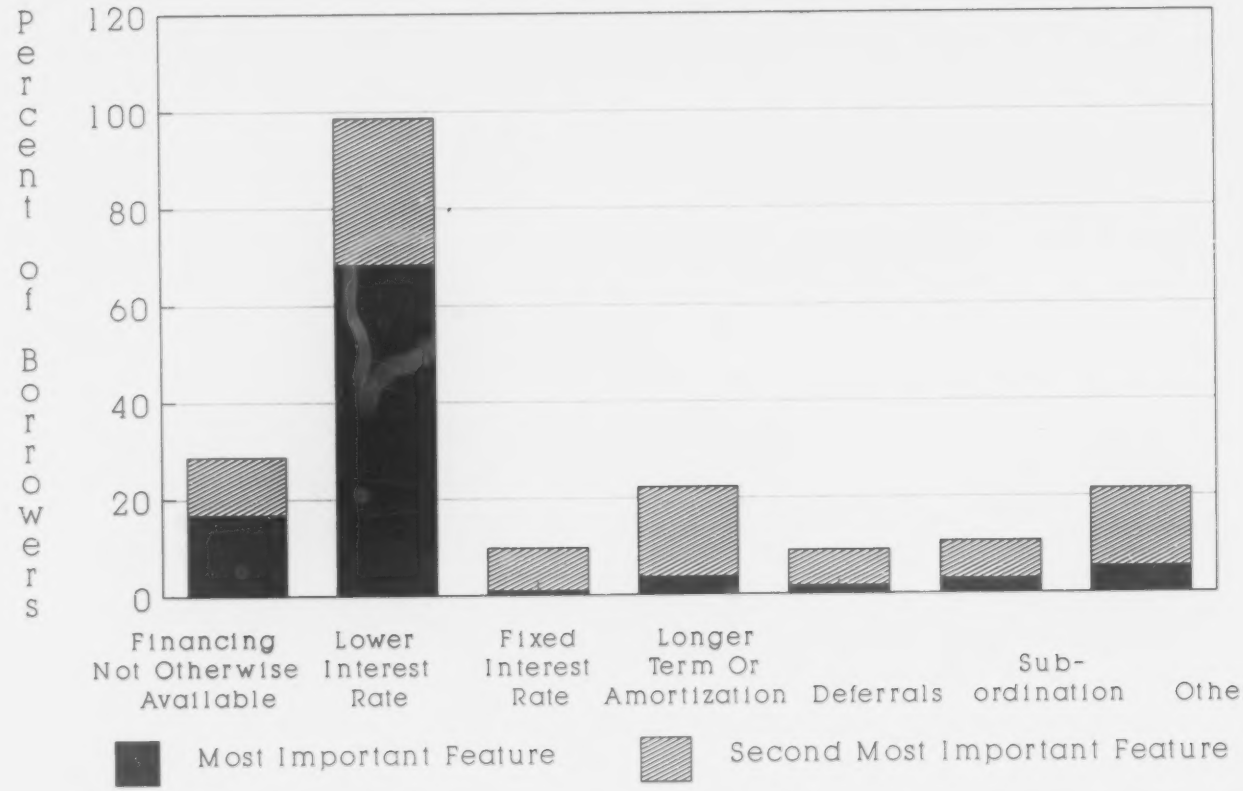
ness development with CDBG funds. While about 15 percent of the companies responding to the borrower survey did receive some type of management assistance, less than 2 percent of the borrowers received the assistance from the community or organization which provided the CDBG loan. Fifteen percent of the borrowers did, however, receive some form of assistance in accessing private financing through the CDBG Program (see Chart 2.9).

Summary

It is clear that the CDBG Program provides businesses with financing on very preferential terms. It offers the type of financing not readily available in the private markets (fixed rates, longer terms, and subordination) and at the same time providing relatively large subsidies through low interest rates and deferrals. Without more in-depth analysis, it is difficult to assess whether the level of financing concessions provided is required to make a project go forward.

Two other findings are noteworthy in terms of how the CDBG Program is being used. First, given the level of other public funding (80 cents for each dollar of CDBG funds), there is evidence that the program is often being used as one tool in relatively complex projects involving a range of federal, state and local financing programs. Second, unlike other state and local financing programs which develop more comprehensive relationships with borrowers, CDBG lenders provided management or technical assistance to the firms being financed in only a few instances.

CHART 2.9
IMPORTANT FEATURES OF CDBG FINANCING



III. JOB AND INVESTMENT IMPACTS OF CDBG BUSINESS LOANS

Determining the development impact of a business financing program is a very complex process. Five factors must be considered in order to measure accurately impacts: the *direct impact* of jobs created or retained by the firm receiving CDBG financing; the *secondary impacts* from jobs created or retained through backward and forward linkages from the borrower into the local economy; the *targeting impacts* – in the case of the CDBG Program, the percentage of jobs created or retained going to low- and moderate-income workers; the *substitution affect*, or the extent to which the loan substituted for other available sources of private capital and employment; and finally the *quality of jobs created or retained*. In addition to these issues, analysis of the development impacts of a program needs to consider *economic stability* – whether the jobs being created are staying in the community or are being lost due to the closure of firms or their relocation out of the area.

Direct Impact and Targeted Impacts

The borrower survey was central to data collection about the job impacts of CDBG financing. It was presumed that the borrower would have the most accurate information about employment levels before and after the CDBG financing and on how the availability of CDBG financing affected the firm's investment decision. It was also presumed that obtaining this information from the borrower would introduce less bias into the estimates of job impact than using information supplied by state CDBG Program administrators, the only other practical source of such information.

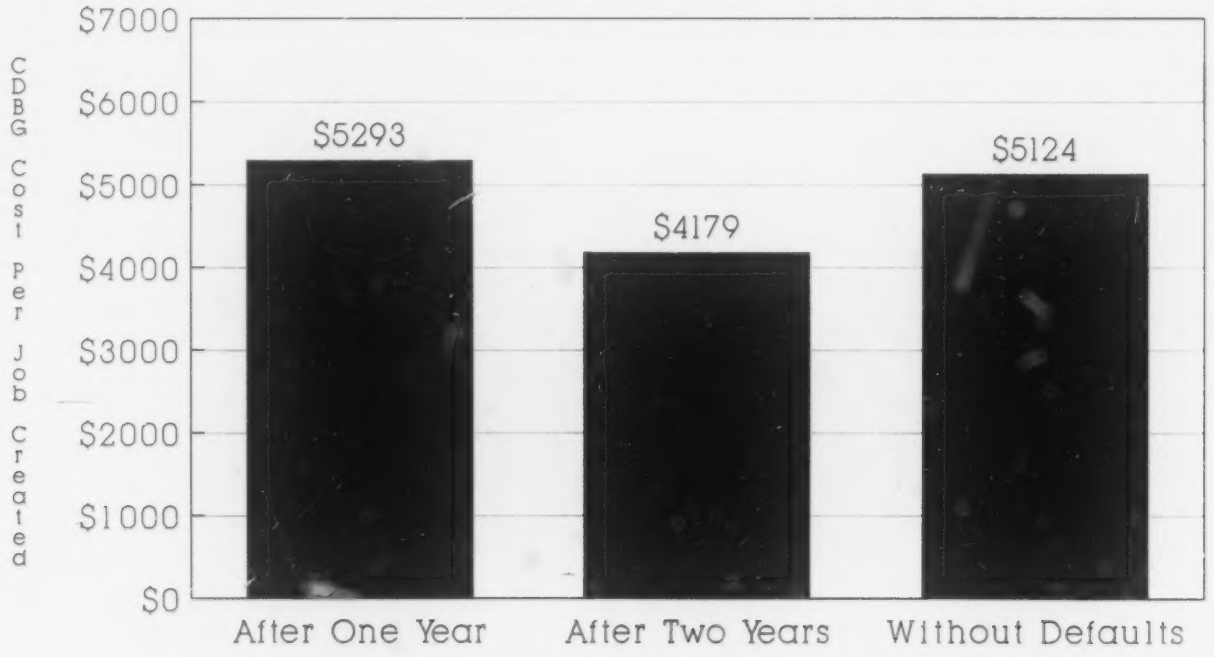
Job creation impact was measured in two steps. First, an estimate of the jobs created or retained by the CDBG financing was derived. The borrower was asked to provide actual employment data at the time of receipt of the financing and at one- and two-year intervals after the financing. The borrower was then asked to estimate what its employment levels would have been at the same one- and two-year intervals had *no* financing been available through the CDBG Program or any other sources it approached at the time. An estimate of the jobs created or retained was derived by subtracting the estimated from the actual figures for each time interval. Because impact was presumed to be closely related to the time interval since the borrower had obtained and invested the funds provided by the CDBG Program, time intervals rather than actual dates or annual averages were used to allow comparison of financings.

Analysis of the borrower survey indicated that of 287 companies which were still operating in the communities through which they received CDBG financing and for which information was available, a total of approximately 15,000 jobs were reported to be retained or created after two years as a result of the financings. The cost to the CDBG Program for each job created or retained was $4,179 two years after the financing (see Chart 3.1). It should be noted, however, that these figures only include companies which were still in business at the time of the borrower survey. The figure does not include the job creation costs for the ninety-nine companies which were confirmed to be out of business at the time of the borrower survey. If the job creation impacts of these firms is presumed to be zero, the cost to the CDBG Program for the creation of the 15,000 jobs is about $5,124.

When looked at as a whole, the number of jobs created or retained as reported by the borrowers is very close to state projections of job creation. Job creation and retention figures on 248 companies were available from both states and borrowers. States reported that these firms were expected to create or retain 13,558 jobs, while the borrowers themselves reported that they actually created or retained about 13,448 jobs. While projected job creation by states and reported job creation by borrowers differ within categories, the aggregate information provided by the states provides a relatively accurate picture of actual job impacts.

What makes the CDBG Program different from many other public financing programs is its targeting of the jobs created and retained through CDBG financing to low- and moderate-income workers. In fact, creating jobs for low- and moderate-income

CHART 3.1
CDBG COST PER JOB CREATED



Without Default: Accounting for 0 Job Creation for Companies Which Were Out-Of-Business

workers is the primary purpose of the economic development projects supported through state CDBG Programs. In order to assess the program's success in meeting this objective, respondents to the borrower survey were asked a number of questions related to their hiring of low- and moderate-income residents and their use of education and training programs.

A high proportion of CDBG borrowers appear to monitor actively the proportion of jobs created or retained as a result of the CDBG financing which are held by low- and moderate-income workers. Eighty-one percent of survey respondents indicated that they were able to provide this information. Survey respondents reported on average that 76 percent of the jobs created or retained as a result of the CDBG financing went to low- and moderate-income workers. This proportion is well above the requirements of the program which call for at least 51 percent of jobs to go to these workers.

Another indication of how the CDBG Program affects who gets the jobs created or retained is the proportion of workers hired by companies through referral from state and local employment services or employment and training programs. According to information provided by borrowers, on average about 28 percent of current workers were hired through these public sources

While review of data on low- and moderate-income hires is important for determining how the CDBG Program increased job opportunities for these workers, it is also important to ask to what extent the program caused firms to *change* their hiring patterns to increase their level of low/mod workers beyond what would have otherwise been the case. One such measurement is the extent to which borrowers increased their use of job training programs and public employment services, generally targeted to low- and moderate-income workers, after receiving CDBG financing. The survey results indicate that half of borrowers increased their use of such programs at least a little after receiving CDBG financing, and over one-fourth increased their use a great deal (see Chart 3.2). This indicates that the financing relationships developed between borrowers and CDBG financing sources had some effect on borrowers' use of such programs.

Financial Substitution

One of the most difficult issues faced by a government or nonprofit financing program is how to avoid financial substitution. When a company could have obtained private sector financing on viable terms without any assistance from the CDBG Program, the public benefits generated by the program become problematic. Unless the case can be made that the company would not have hired or retained low- and moderate-income workers (the key goal of the CDBG Program) without the financing, it is difficult to argue that the CDBG financing is responsible for the employment impacts.

To avoid substitution, many public financing programs require that borrowers provide evidence that they cannot obtain private financing. Results from the borrower survey indicate that the majority of CDBG borrowers did seek private financing prior to receiving CDBG financing. Four out of five borrowers surveyed contacted at least one bank prior to contacting the CDBG financing source and close to 60 percent contacted at least two commercial banks. Two-thirds of the firms surveyed provided written financing proposals to at least one bank (see Chart 3.3).

The survey results indicate that in most cases the availability of CDBG financing had an important impact on the borrowers' investment decisions. Only about 15 percent of survey respondents indicated that they would have in no way altered their investment decision had the CDBG financing not been available. Almost half indicated that the availability of CDBG financing made the difference between making and not making the investment in the community. These firms would either have canceled the investment, made the investment in or moved the firm entirely to another community, or gone out of business altogether had the CDBG financing not been available. In addition, more than one-third would have either delayed or scaled back the investment, or both (see Chart 3.4).

Another way of analyzing the financial substitution issue is to find out the experience of CDBG borrowers in seeking financing from private financial institutions prior to approaching the CDBG Program. The survey results indicate that a large

CHART 3.2
USE OF EMPLOYMENT AND TRAINING PROGRAMS

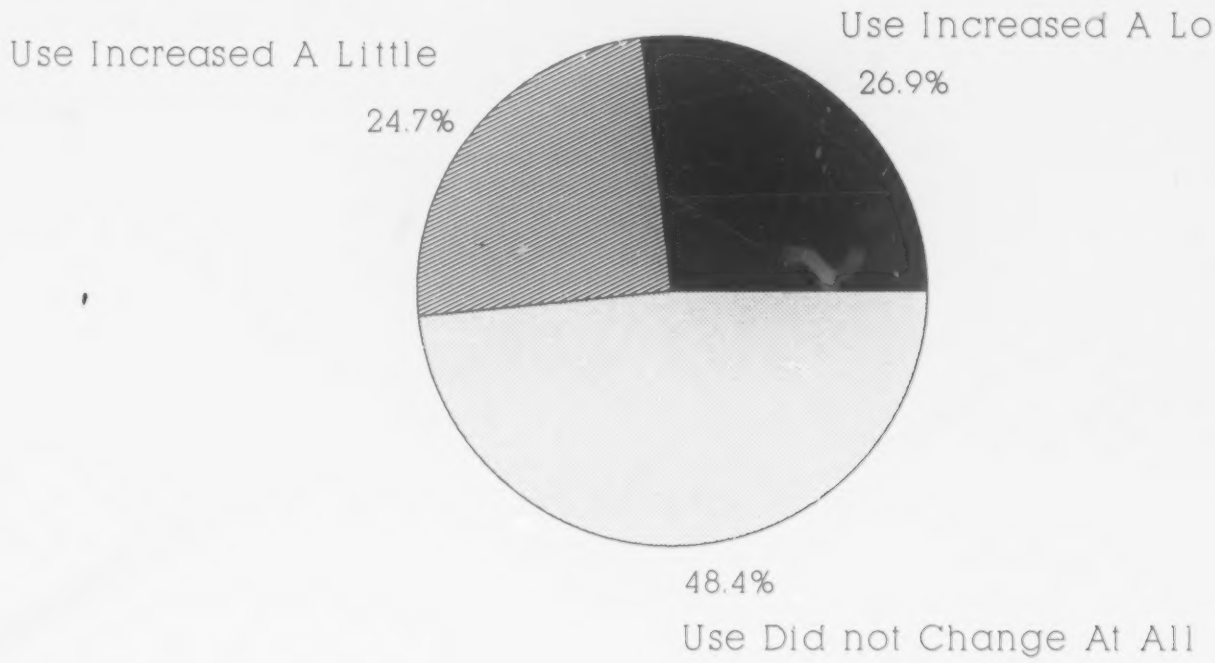
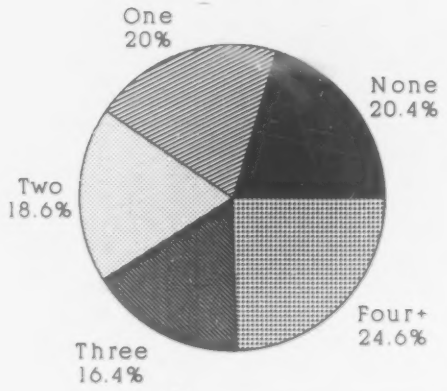
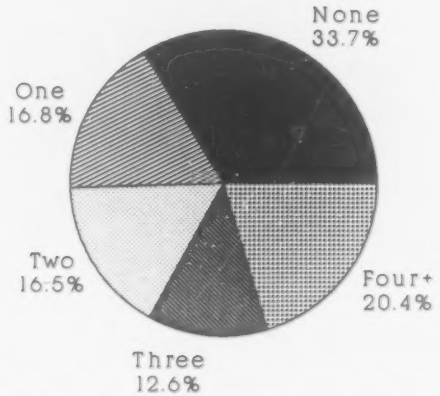


CHART 3.3
EXPERIENCE ACCESSING PRIVATE FINANCING

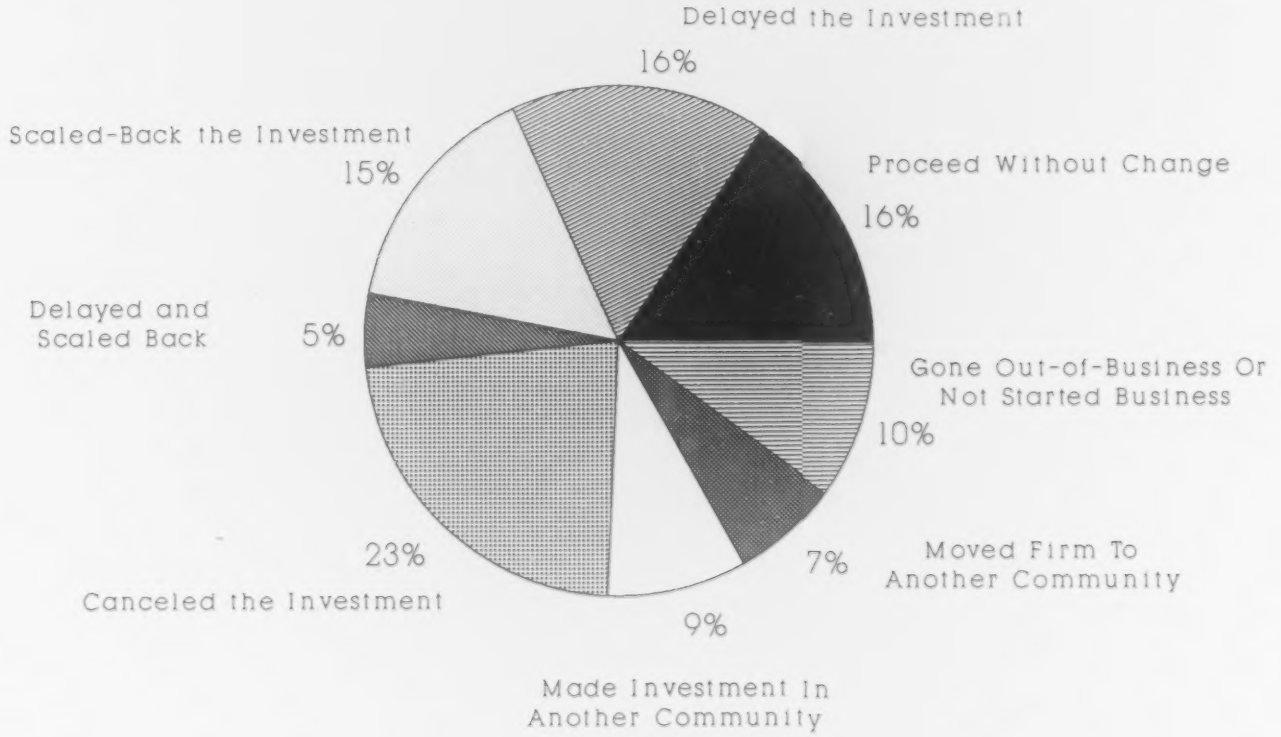


Number of Financing Sources Contacted



Number of Financing Sources Provided With Written Proposal

CHART 3.4
ACTION WITHOUT CDBG FINANCING



majority of survey respondents who requested financing from a private source were unable to obtain either the amounts or the types of financing needed to make the proposed investments. Forty-five percent could obtain only part of the financing through private sources, and an additional almost 10 percent could obtain no financing at all. Almost one-fifth would have been able to obtain financing, but on terms which they believed could not be supported through their cash flows. At the same time, fully one-quarter of respondents who sought private sector financing indicated that they could have obtained the financing they needed on terms they could afford, but that the CDBG financing was simply more attractive. The provision of CDBG financing to these firms is not likely to have resulted in new investment or job creation, though it might have affected their hiring of low- and moderate-income workers (see Chart 3.5).

A final way of analyzing the financial substitution issue is to look at the financial situation of the firms receiving CDBG financing. Firms that are well established and in a strong financial position are less likely to need public sector financial assistance than firms without a track record or experiencing financial problems. Among CDBG borrowers, about one-quarter (23.5 percent) appeared to be in the former category. These firms characterized themselves as established companies with healthy profits. It is likely that most of these firms could have obtained financing in the private market, though there may have been other reasons to give them CDBG money, such as the firm's commitment to hire low- and moderate-income workers. The balance of firms that characterized themselves as either startups, established firms experiencing operating losses, or established firms just breaking even or with variable profitability were more likely to have problems obtaining private financing.

The above data indicate that the availability of CDBG financing influenced the borrower's investment and employment decisions in a large majority of cases. At most, 20 percent to 25 percent of these firms could have obtained the financing they needed to make planned investments from private financing sources.

To get a more accurate sense of the job creation impact of the CDBG Program the response to the question "what would have occurred had the CDBG funds had not been available" was used to adjust the job creation or retention estimates to account for the degree to which the CDBG financing substituted for other financing sources. Job creation and retention was not counted for those firms which noted that they would have proceeded with the investment without change and job creation was "discounted" for those firms which noted that the financing affected the timing or scale of their investment. When job creation impacts are corrected for financial substitution, the two-year job creation cost jumps from $4,179 to $5,324.

Given the focus on hiring workers from low- and moderate-income households in the CDBG Program, a case could be made that even if the firm could have received conventional financing, it would not have hired low- and moderate-income residents without the preferential financing terms provided through the CDBG Program. However, it is not clear from the available data whether or not firms would have hired low- and moderate-income workers without CDBG financing.

Secondary Impacts

The destination of goods and services produced by firms receiving CDBG financing indicates that CDBG financings have significant indirect job impacts in the communities in which they are made. According to survey respondents, a high proportion of the businesses receiving CDBG financing are "traded" firms, that is, firms that sell a high proportion of their products outside the communities in which they are located. This means that wealth from the sale of products is imported from elsewhere, generating additional local purchases and job creation, rather than simply recirculated from one local resident to another. Ninety-three percent of borrowers sell over 50 percent of their products to customers living more than 50 miles away from their communities. On average, financing recipients made 61 percent of their sales to customers more than 50 miles away (see Chart 3.6). In addition, a surprisingly large number of borrowers, about 25 percent, export at least some goods and services outside the U.S..

CHART 3.5

EXPERIENCE SEEKING CONVENTINAL FINANCING

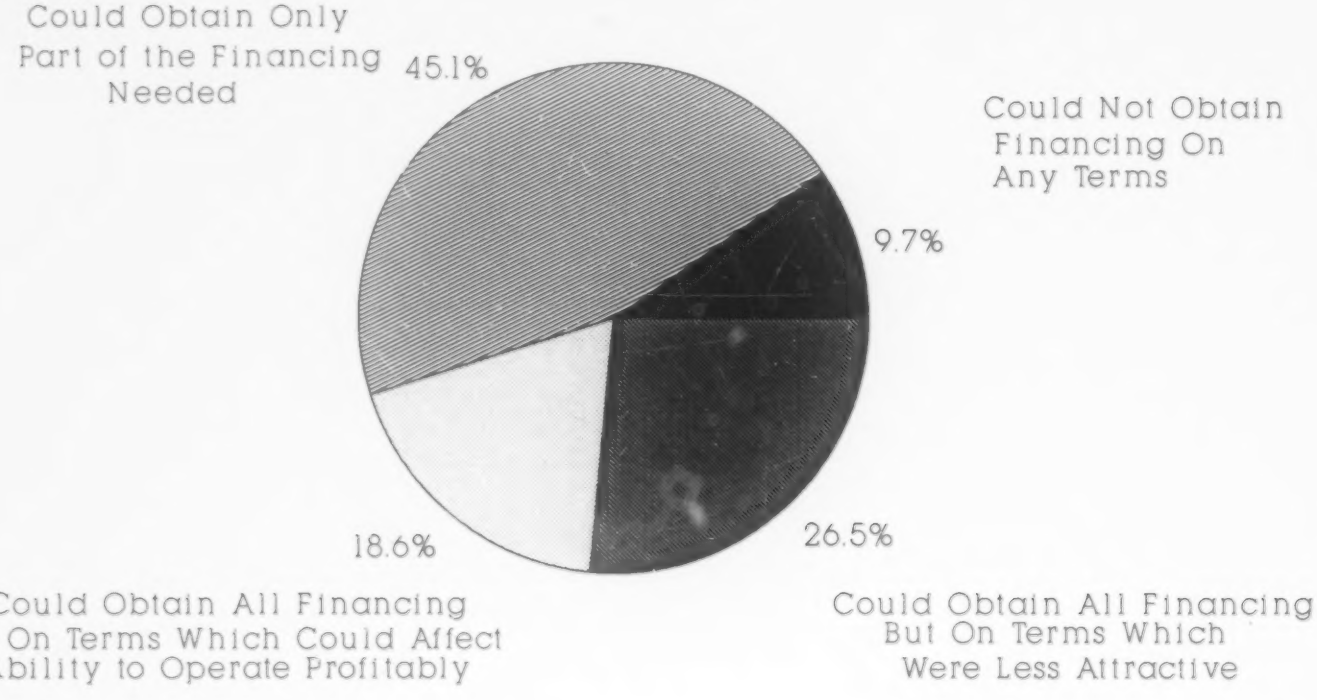
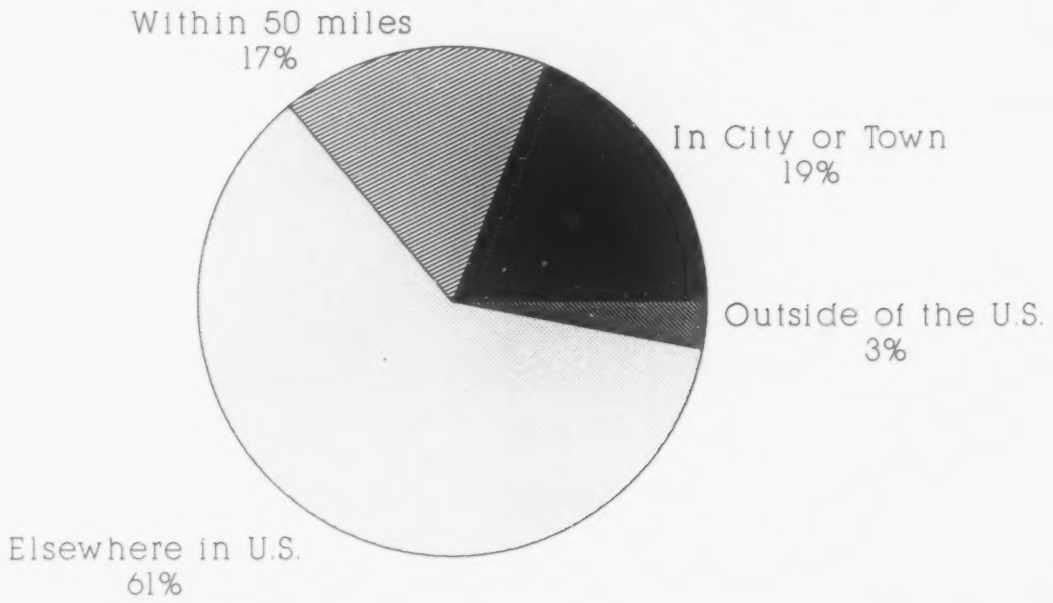

Could Obtain Only Part of the Financing Needed
45.1%
Could Not Obtain Financing On Any Terms
9.7%
18.6%
26.5%
Could Obtain All Financing But On Terms Which Could Affect Ability to Operate Profitably
Could Obtain All Financing But On Terms Which Were Less Attractive

CHART 3.6
MARKETS SERVED BY CDBG BORROWERS


Average Percentage of Goods and Services Sold To Customers in the Following Areas
Within 50 miles 17%
In City or Town 19%
Outside of the U.S. 3%
Elsewhere in U.S. 61%

Job Quality

A high proportion of the jobs created or retained as a result of CDBG financing are low paying. Over one-third paid wages of $200 per week or less—$10,400 or less on an annual basis. Close to 40 percent paid between $201 and 300 per week, $10,400 and $15,600 on an annual basis. As a point of comparison, while about 70 percent of the jobs in firms financed through the CDBG Program paid less than $300 a week, the median weekly earnings in the U.S. as a whole (including metropolitan areas) in 1987 was $373. Thus, while only 30 percent of employees of firms receiving CDBG financing earned over $300 a week, over 50 percent of U.S. workers earned over $373 a week. To some extent, these figures are not surprising given that the CDBG Program is targeted to providing employment opportunities to low- and moderate-income workers (see Chart 3.7). Moreover, until recently, HUD regulations stipulated that one way of documenting that the use of funds benefited low- and moderate-income individuals was to presume that jobs falling into certain low-wage categories went to low- and moderate-income workers.

While not particularly high-paying, jobs created and retained as a result of CDBG financing generally provide stable employment opportunities. On average, less than four percent of these jobs were temporary or seasonal. CDBG borrowers also tended to provide full-time employment opportunities. On average, 96 percent of the jobs in firms receiving CDBG financing were year-round, and over 85 percent were full-time (see Chart 3.8).

While most of the jobs created and retained through CDBG loans are permanent and full-time, workers do not appear to stay in the jobs for a very long duration. Job turnover is rapid, with an average of one-third of the jobs becoming available annually as a result of quits and dismissals. Rapid turnover may signal that jobs are not sufficiently attractive to retain employees for more than a short duration. This may be related to the relatively low wages paid by many of the jobs.

Economic Stability

The economic impact of a public financing program is affected by its success in financing firms which are viable over the long run. Moreover, the firms financed must remain in the community or else the anticipated public benefits will all be lost. In other words, while a CDBG loan may create jobs for one or two years, its long-term impacts are minimal unless the firm it finances remains in operation at the targeted location.

The stability of the firms receiving financing was looked at in two ways. First, states were asked to provide information on the status of their loans. Information provided by states on loan status covered a little over one-half of the loans in the data base. Among loans for which information was provided, 82 percent were either current or totally repaid. Another 3.3 percent were delinquent, 8.4 percent were in default (over 60 days delinquent), and 6.2 percent were written off (see Chart 3.9).

The proportion of companies in the borrower survey which were confirmed as out of business provides additional evidence on economic stability. Information on the status of 596 companies was gathered as part of the business survey. Of this total, 99 (almost 17 percent) were confirmed to have gone out of business and another 3 (.5 percent) to have moved to a new location. Another 11 percent of the companies which were in business and responded to the survey were in default (over 60 days delinquent) in their loan payments. This information provides evidence that a relatively large number of CDBG financed firms (over 25 percent) may not be economically stable.

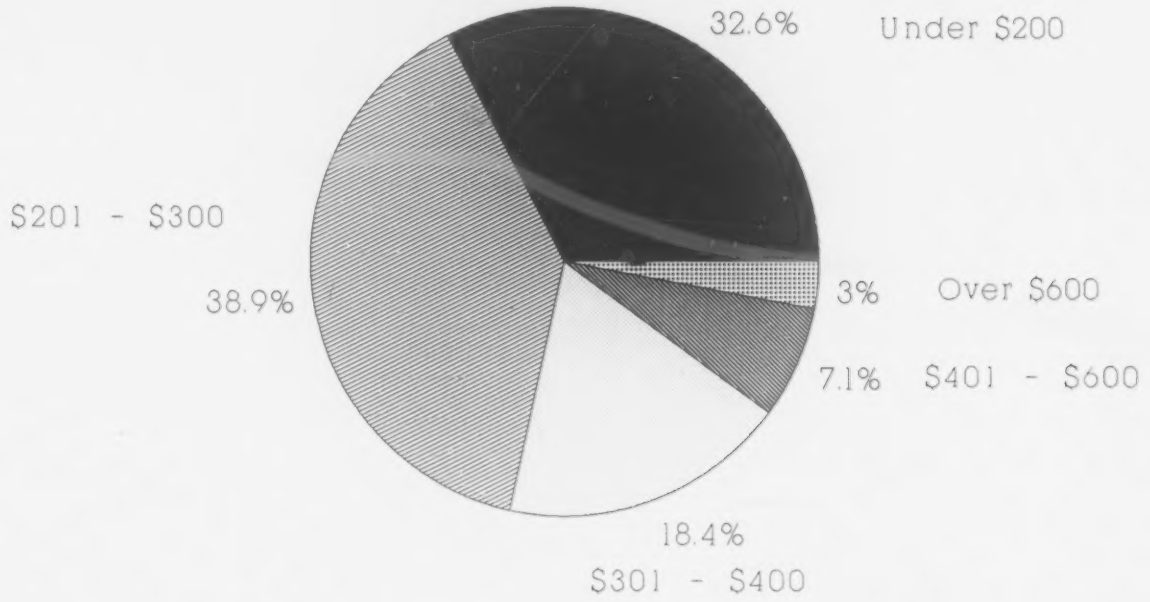
Conclusions

Information from the survey of borrowers of the CDBG Program provides evidence that CDBG funds have met the program objectives of creating or retaining jobs for workers from low- and moderate-income households. For about three quarters of the companies surveyed, the investments made and the jobs created or retained as a result of the financing would not have been possible if they had to rely on conventional sources of financing.

Two issues related to the job impacts of the CDBG Program are worth noting:

CHART 3.7
WAGES IN FIRMS RECEIVING CDBG FINANCING

Percentage of Employees Earning the Following Average Weekly Earnings



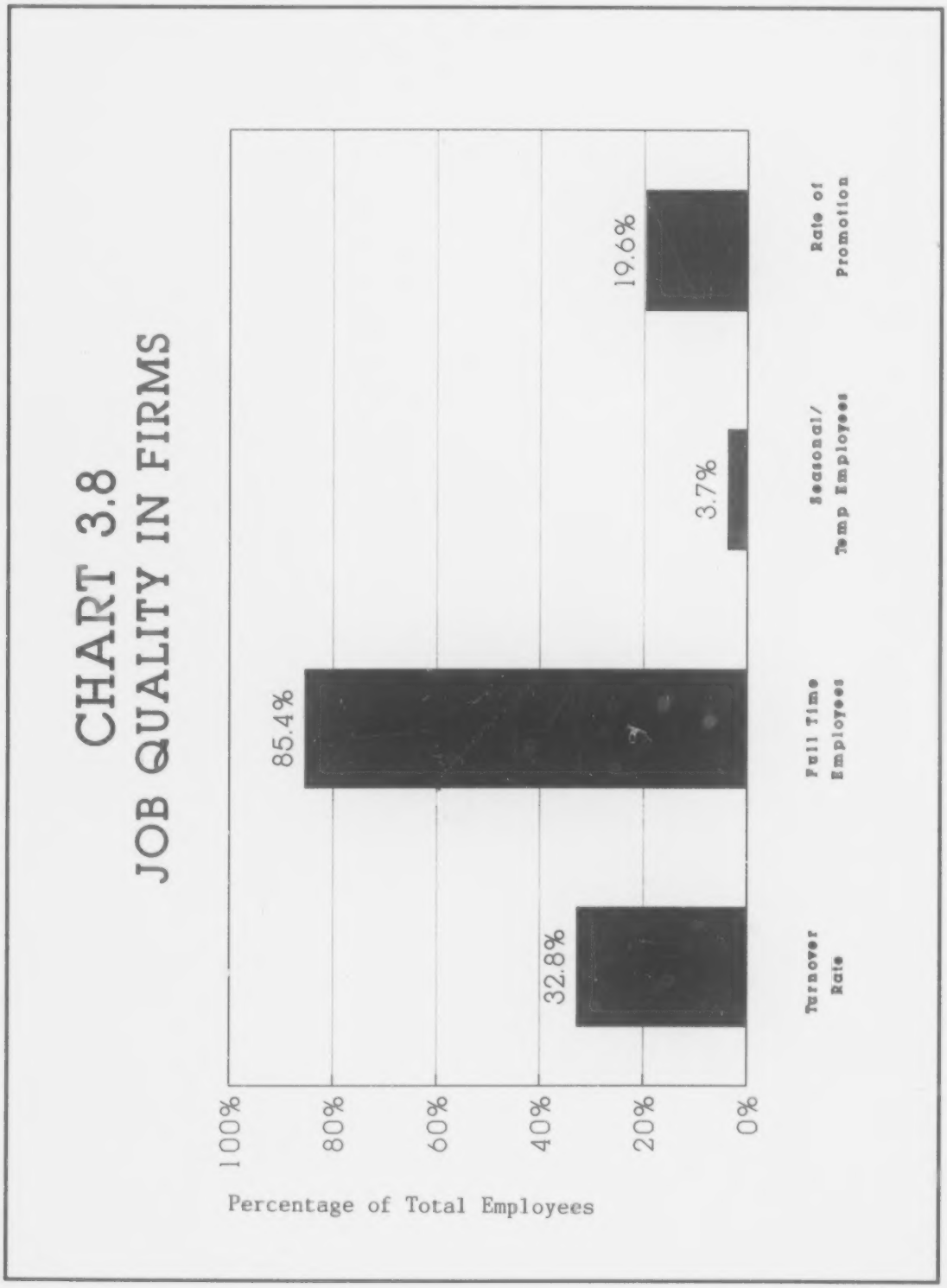
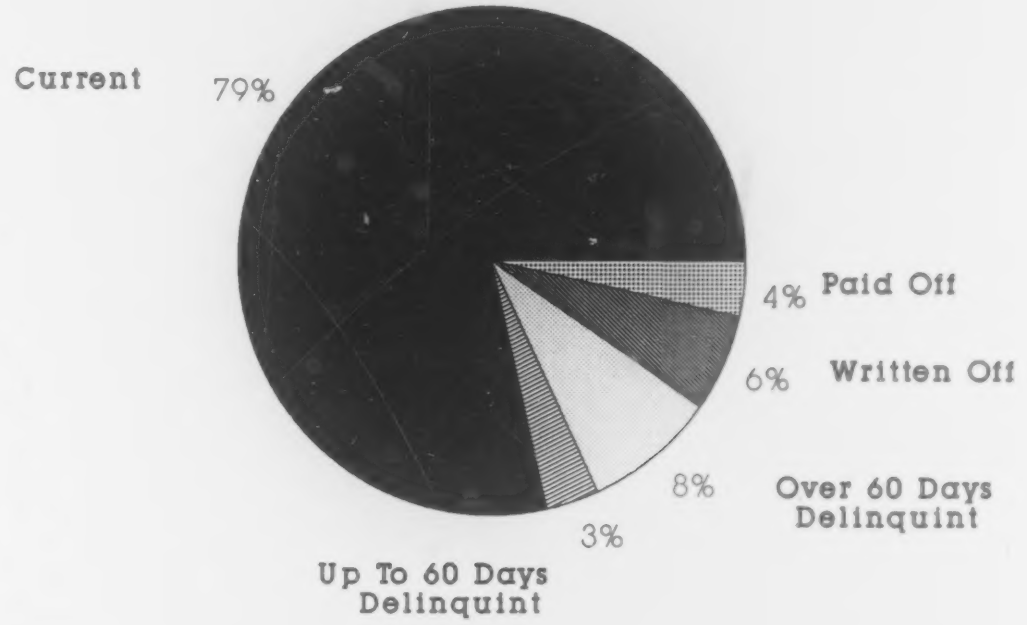


CHART 3.8
JOB QUALITY IN FIRMS
100%
80%
60%
40%
20%
0%
Percentage of Total Employees
32.8%
85.4%
3.7%
19.6%
Turnover Rate
Full Time Employees
Seasonal/ Temp Employees
Rate of Promotion

CHART 3.9

STATUS OF LOANS
(N=1196)



1. The issue of the quality of jobs created through the CDBG Program requires further investigation. The key question here is whether the program promotes investments in firms which provide relatively low-paying jobs as a result of its emphasis on hiring low- and moderate-income workers? In fact, jobs for low- and moderate-income workers were translated into low-wage, entry level jobs. While there is some inevitable relationship between the income of workers and the quality of jobs, efforts could be made to promote the creation of higher-quality jobs which are then targeted to low-income workers through better use of and coordination with employment and training programs.

2. Further attention should be given to the viability of the firms being financed through the CDBG Program. Since the program provides financing to higher-risk firms which often do not have access to conventional financing sources, it is inevitable that the default and bankruptcy rate will be higher than that which is found among conventionally financed firms. However, there is some evidence that the default rate and the number of firms which have gone out of business is high, even for a public sector "gap" financing program. While it was not within the scope of this project to look at how loans are being evaluated and monitored, the high level of instability of CDBG assisted firms may point to inadequate attention on the part of the states and communities involved in the financings to the financial viability of the borrower.

IV. CHARACTERISTICS OF BUSINESS LOANS IN RURAL COMMUNITIES

Overview of CDBG Lending in Rural Communities

Since the CDBG Program is such a critical resource for economic development efforts in rural communities, it is important to look at the characteristics of the business loans in rural communities and consider differences in borrower characteristics, type of financing, and development impacts between rural and urban communities and in different types of rural communities.

The first question which needs to be addressed is how to define "rural" vs. "non-rural" for the purposes of analysis. Two different measures of "ruralness" are used:

1. *Metropolitan Counties vs. Nonmetropolitan Counties:* The most commonly used measure to identify a rural area is to distinguish between those counties which are part of metropolitan statistical areas as defined by the U.S. Census, and those counties which are not part of a metropolitan area.

2. *Proximity to an Urban Center:* There are many communities within a metropolitan area which are outlying and far enough away from the urban center to almost qualify as rural. Moreover, in nonmetropolitan counties there are degrees of "ruralness" depending on distance from a major urban center and the existence of an urbanized area. To account for this, a combined measure was developed which included a distinction in metropolitan counties between "central" counties and "outlying" counties, and distinctions amongst nonmetropolitan counties based on size and proximity to a metropolitan area. The categories under nonmetropolitan counties were developed by the U.S. Department of Agriculture by Calvin Beales. The categories for metropolitan counties were developed by the U.S. Office of Management and Budget. These distinctions are as follows:

1. Central County in a Metropolitan Area.

2. Outlying County in a Metropolitan Area.

3. Nonmetropolitan County with an urban population of 20,000 or more adjacent to a metropolitan area.

4. Nonmetropolitan County with an urban populations of 20,000 or more not adjacent to a metropolitan area.

5. Nonmetropolitan county with an urban population of less than 20,000 adjacent to a metropolitan area.

6. Nonmetropolitan county with an urban population of less than 20,000 not adjacent to a metropolitan area.

7. Completely rural area adjacent to a metropolitan area.

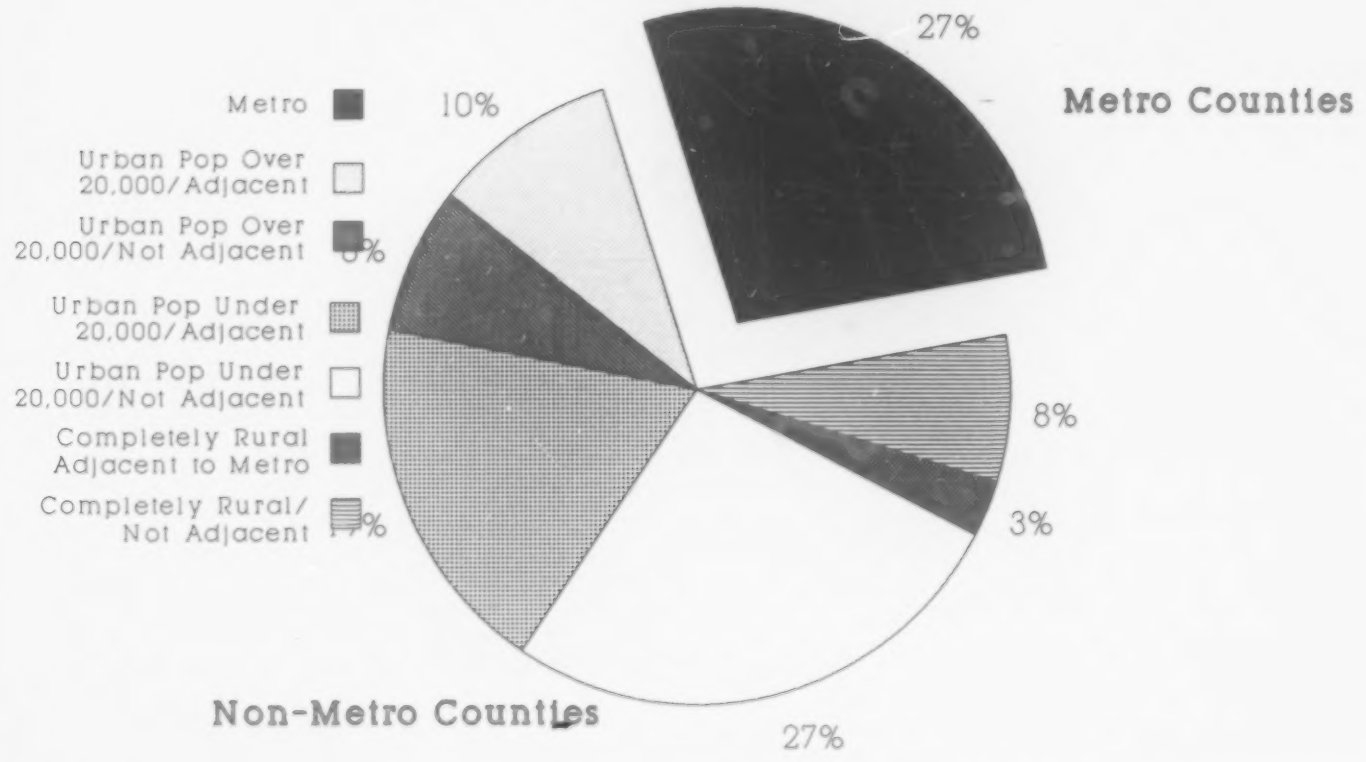
8. Completely rural area not adjacent to a metropolitan area.

Some analysts consider the first four types of counties "urban" and the remaining counties "rural."

Analysis of the business loan projects funded with state CDBG funds between 1982 and 1986 provides clear evidence that these funds have been used predominantly in rural areas. About 73 percent of the businesses financed during this period were in non-metropolitan counties (see Chart 4.1). Nationally, in 1986 about 102 million people lived in non-entitlement communities which were eligible for CDBG funding through their state rather than directly from HUD. According to HUD, approximately 55 percent of the non-entitlement population lived in nonmetropolitan areas and 45 percent in metropolitan areas. Thus, consistent with the larger proportion of the non-entitlement population living in nonmetropolitan areas, these communities received a larger proportion of state CDBG funds for business lending.

The second definition of "rural" provides a finer distinction of the rural nature of the communities receiving CDBG funds. Counties characterized as

CHART 4.1
DISTRIBUTION OF BUSINESS LOANS BY TYPE OF COUNTY



"completely rural," whether adjacent or not adjacent to a metropolitan area, by the U.S. Department of Agriculture received about 9.6 percent of the CDBG business loan projects during the 1982 to 1986 time period. An additional 26 percent of the business loans went to counties which were predominantly rural, having an urban population of less than 20,000 and not adjacent to any metropolitan area. In terms of metropolitan counties, about 18 percent of the projects went to central counties in metropolitan areas and 9 percent of the projects went to outlying counties in metropolitan areas. The distribution of CDBG loan projects to different types of counties matches the overall distribution of counties in the U.S. (see Chart 4.2).

The type of counties receiving CDBG funds were further categorized based on their economic base. In addition to understanding the distribution of projects by classifications of "rural" and "nonrural," it was important to understand the types of "rural"-counties which were receiving CDBG funds. The U.S. Department of Agriculture has developed a classification system which divides nonmetropolitan counties into various categories based on their economic structure. The so-called "Ross-Green" code has the following categories:

1. *Agricultural Counties:* Those nonmetropolitan counties in which farming contributed a weighted average of 20 percent or more to proprietor income.

2. *Manufacturing Counties:* Those counties in which manufacturing contributed 30 percent or more of total labor and income.

3. *Mining Counties:* Those counties in which mining contributed 20 percent or more to labor and proprietor income.

4. *Federal Lands Counties:* Those counties in which federal land is 33 percent or more of total land area.

5. *Government Counties:* Those counties in which local, state, and federal government contributed 25 percent or more of total labor and proprietor income.

6. *Retirement Counties:* Those counties in which there was a 15 percent or more immigration of people over the age of 60 between 1970 and 1980.

A relatively large proportion of the counties which have received economic development funds through the CDBG Program have a large manufacturing base. About 31 percent of the economic development projects funded through the CDBG Program between 1982 and 1986 went to counties classified as "manufacturing" by the Ross-Green Code. In contrast, nationally only 22 percent of the counties could be classified as manufacturing.

The states also seem to steer away from counties which are dominated by agriculture. While about 23 percent of all U.S. counties were classified as "agricultural" by Ross-Green, only 13 percent of the counties receiving CDBG funds were classified as agricultural. In other economic base categories – mining, federal lands, government and retirement – there was a slightly lower proportion of counties receiving CDBG assistance than the proportion of such counties in the U.S. as a whole.

Borrower Characteristics in Rural Communities

Very few statistically significant differences were found when comparing borrowers in rural and metropolitan communities. There were, however, a number of important characteristics, which while not all statistically significant, may distinguish CDBG borrowers in rural communities from those in urban communities.

First, borrowers in rural communities tend to be smaller. About 68 percent of firms financed in nonmetropolitan counties had nineteen or fewer employees, whereas only about 57 percent of firms financed in metropolitan counties were this small. At the same time, less than 16 percent of firms financed in nonmetropolitan counties had 50 or more employees compared to almost 25 percent of firms in metropolitan counties (see Chart 4.3). Within rural areas, firms in completely rural counties both adjacent and not adjacent to metropolitan areas had the highest percentage of small firms (see Chart 4.4).

CHART 4.2
DISTRIBUTION OF BUSINESS LOANS BY TYPE OF COUNTY

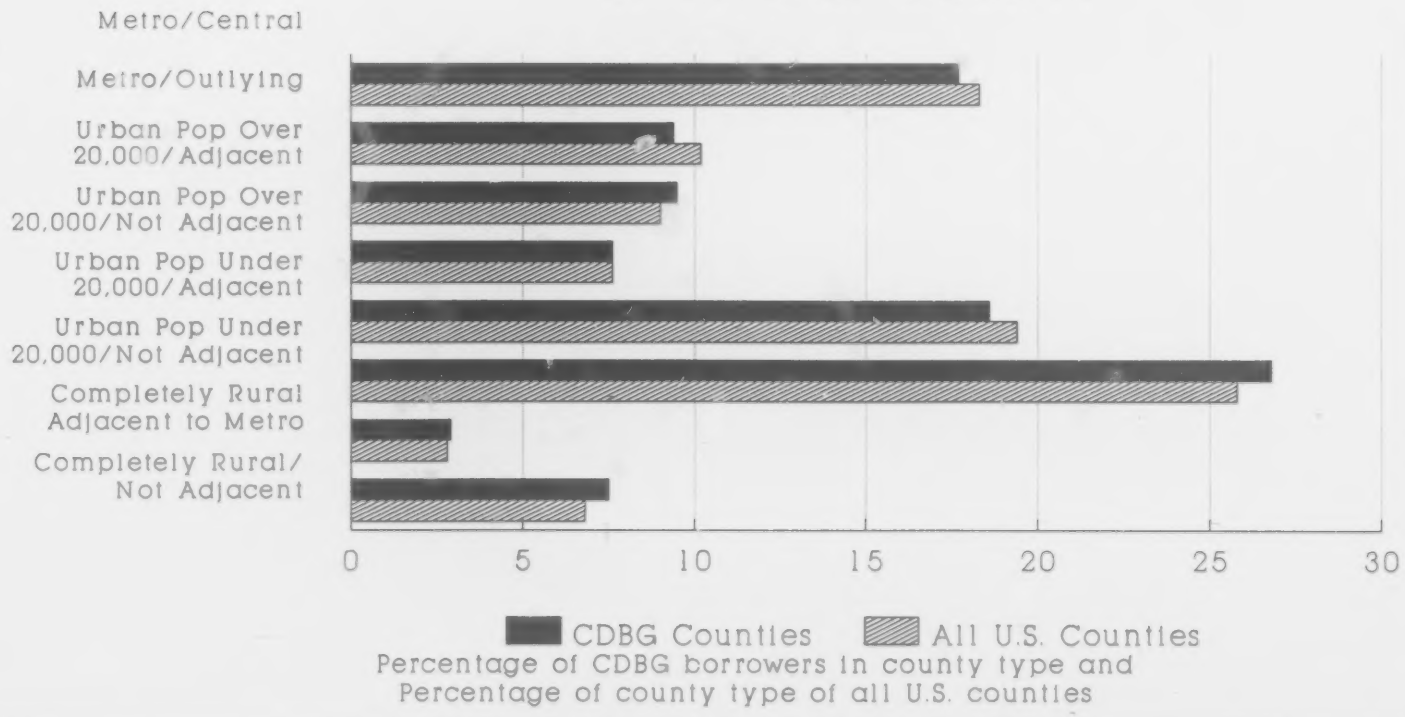


CHART 4.3
SIZE OF BUSINESS BY TYPE OF COMMUNITY

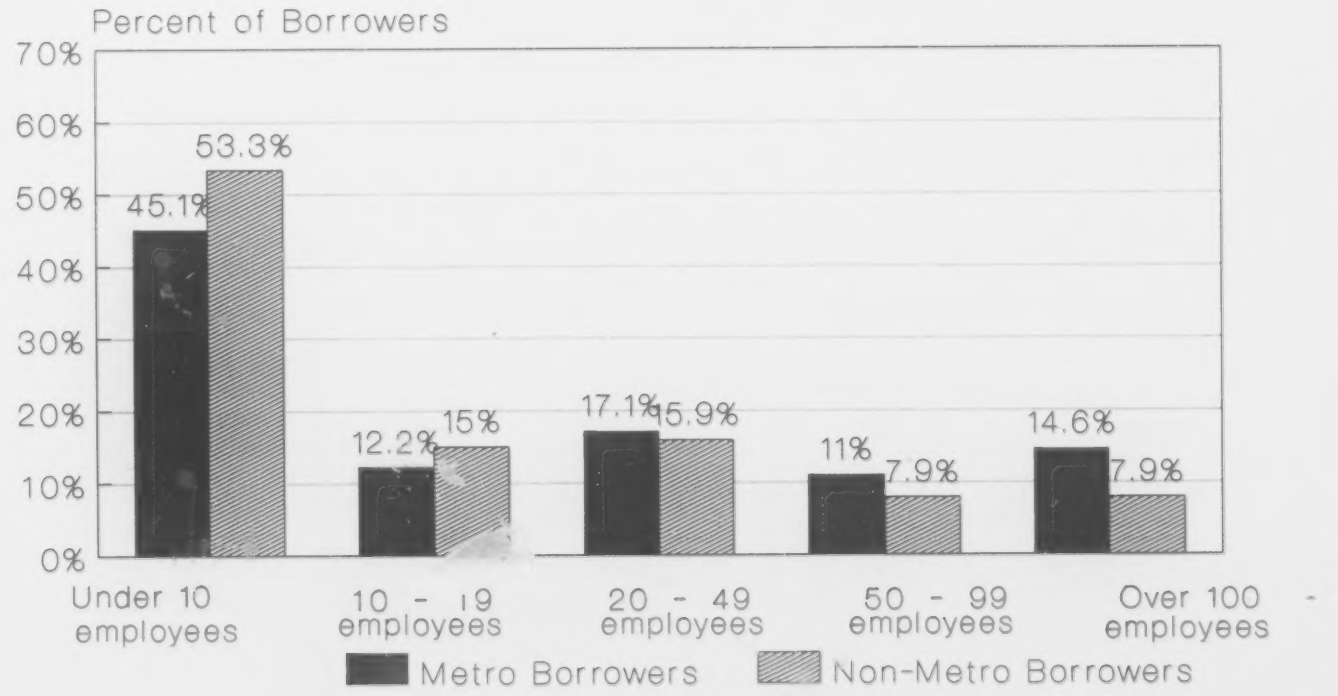
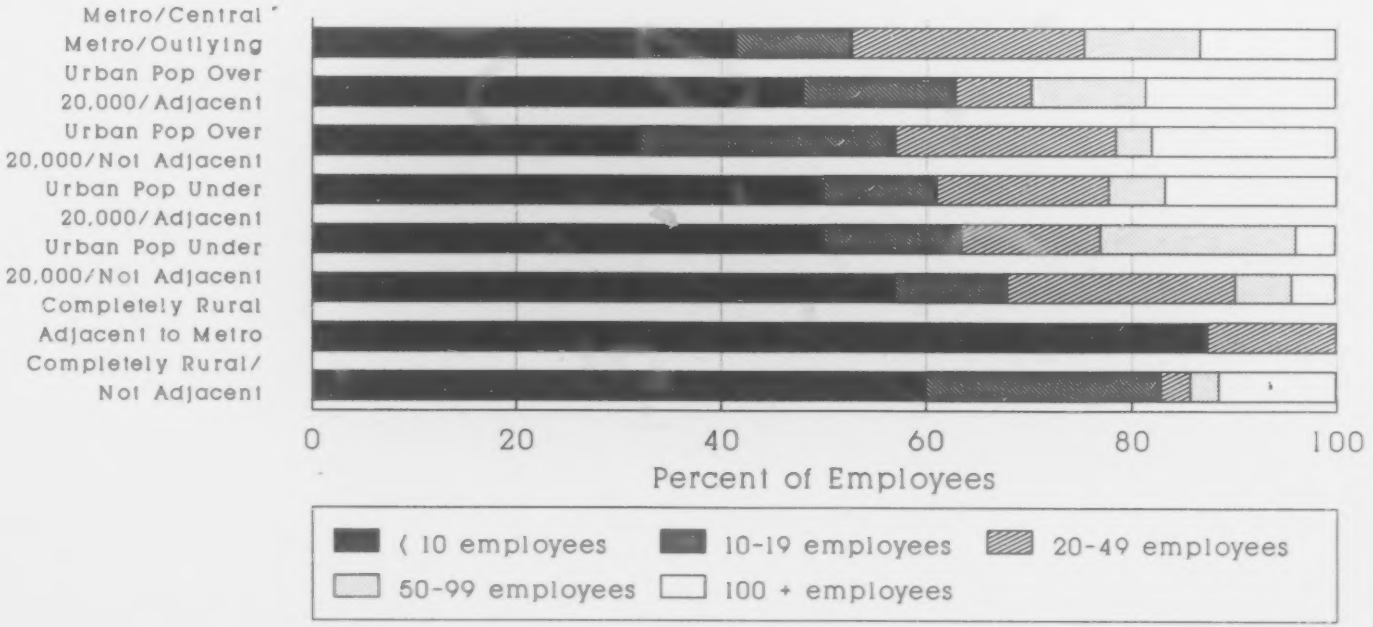


CHART 4.4
FIRM SIZE
BY TYPE OF COUNTY



With respect to the type of rural community, federal lands counties and poverty counties had the highest proportion of small firms, while manufacturing and mining counties had the highest proportion of large firms. The differences in size in agriculturally oriented and manufacturing oriented rural communities were found to be statistically significant.

Second, according to data gathered from the state survey, borrowers in nonmetropolitan counties are somewhat more likely to be startups and branch plants while metropolitan borrowers are more likely to be relocations, both intrastate and interstate. This indicates that loans in rural areas are more likely to create new economic activity and less likely to simply shift activity from one locale to another. These differences were statistically significant. This data from the state survey is supported by the results of the borrower survey. According to respondents' own characterizations of their stage of development (a different one than used for the state survey – one more oriented to determining the financial condition of the firm at the time of the loan), borrowers in non-metropolitan counties appear more likely to be startups with long-term profitability horizons and less likely to be established, healthy firms than borrowers in counties (see Chart 4.5). This difference was not found to be statistically significant, however.

Third, while rural and urban CDBG borrowers differ in size and stage of development, they differ little in their ownership status. Roughly the same proportion of borrowers in metropolitan and nonmetropolitan counties are independent and locally-owned, branches or subsidiaries of firms headquartered elsewhere, and franchises. There is, however, one dimension of ownership status on which urban and rural borrowers differ. *A higher proportion of survey respondents from nonmetropolitan counties were women-owned whereas a higher proportion of non-rural borrowers were minority-owned.* The latter is expected in light of the higher concentrations of minorities in non-rural areas. This difference was not statistically significant, however (see Chart 4.6).

Finally, while the proportion of borrowers in manufacturing and service industries was very similar in rural and metropolitan counties, within manufacturing there were some differences. Businesses in natural resource based industries - food processing and wood products - and transportation equipment were more dominant in nonmetropolitan counties, while a higher proportion of firms in metal working and machinery were found in metropolitan counties.

Characteristics of Financing in Rural Communities

The characteristics of the CDBG financings themselves differ according to whether the financings were in rural or urban areas. *First, loans in urban areas tended to be larger than those in rural areas.* About 70 percent of loans in metropolitan counties were for over $100,000 vs. about 60 percent in nonmetropolitan counties. In contrast, only about 8 percent of loans in metropolitan counties were for less than $25,000 compared to over 13 percent in nonmetropolitan counties (see Chart 4.7). Loans were particularly small in rural areas adjacent to metropolitan areas. Firms in these areas also tended to be service firms, as indicated by a very low percentage of traded goods and services. This may account for their small size (see Chart 4.8).

Second, differences in financing terms among rural and non-rural borrowers indicate that a higher percentage of loans to rural borrowers were designed to stabilize or reduce debt service while a higher percentage of loans to non-rural borrowers were designed to shift risk from participating private financing sources to the CDBG lender. A higher percentage of borrowers in nonmetropolitan counties received principal or interest deferrals and received fixed-rate financing. This may be attributable to the higher percentage of startups receiving financing in these areas. Startups need reduced debt service in early years to help them weather initial losses. A higher percentage of borrowers in nonmetropolitan counties also received subordinated financing, an indication that they are higher-risk firms. These results may indicate that loans in urban areas are more oriented to attracting firms through financing incentives whereas loans in rural areas are more frequently designed to provide capital access to risky firms.

Third, loans in rural and urban areas also varied by their use. A higher proportion of loans in

CHART 4.5
FINANCIAL SITUATION PRIOR TO FINANCING

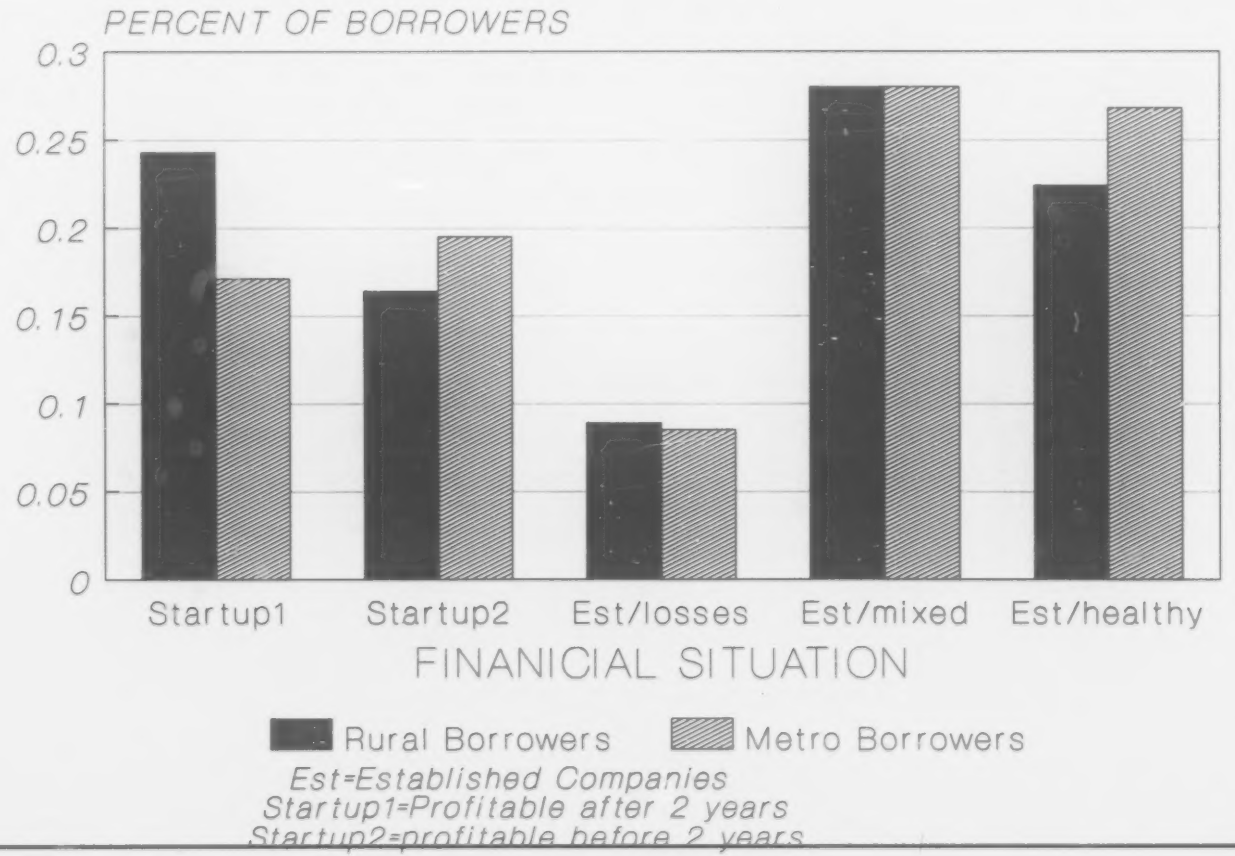


CHART 4.6
CHARACTERISTICS OF BUSINESS OWNER BY TYPE OF COMMUNITY

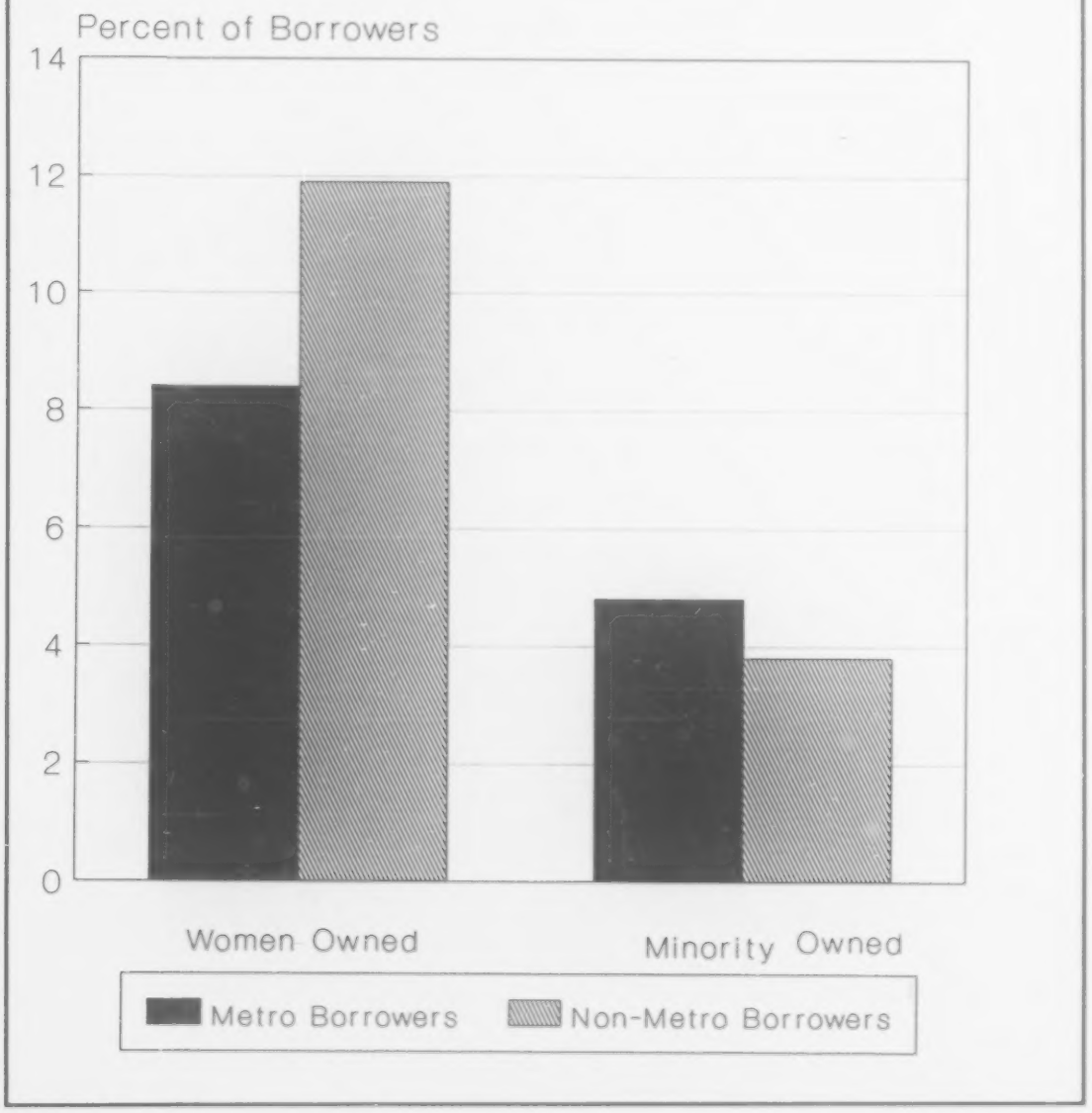


CHART 4.7
SIZE OF LOAN
BY TYPE OF COMMUNITY

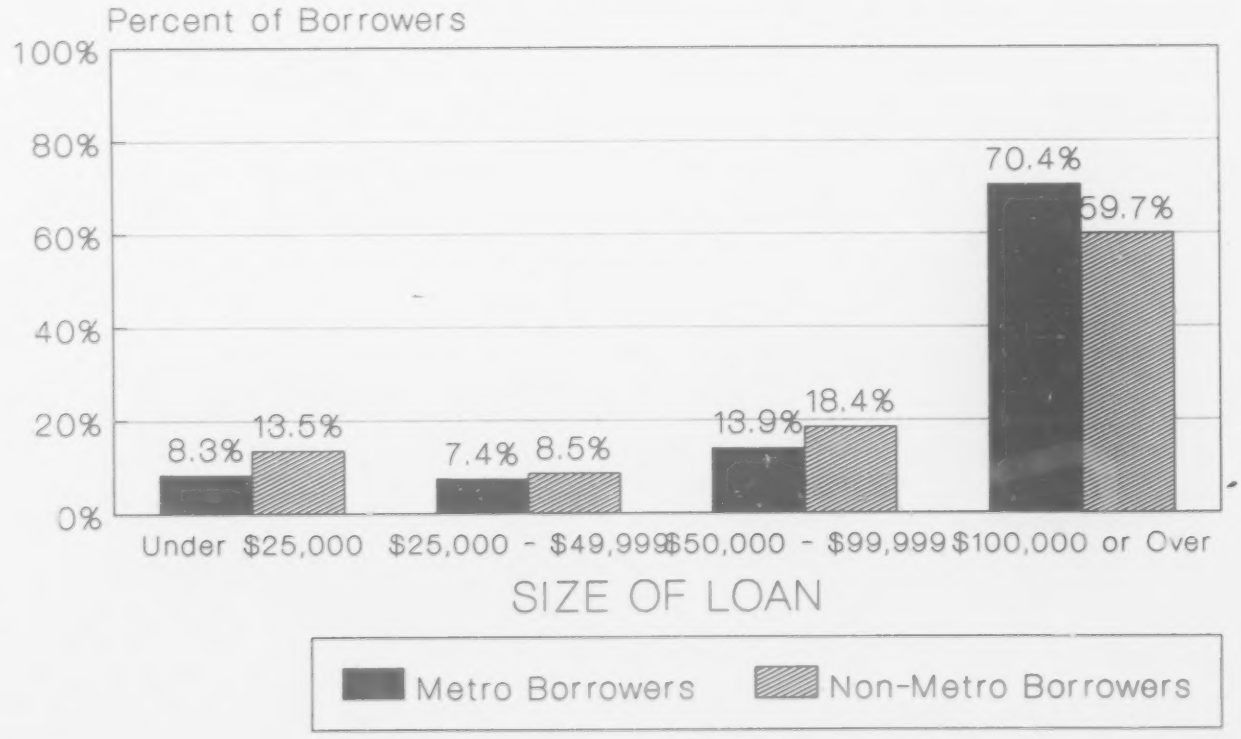
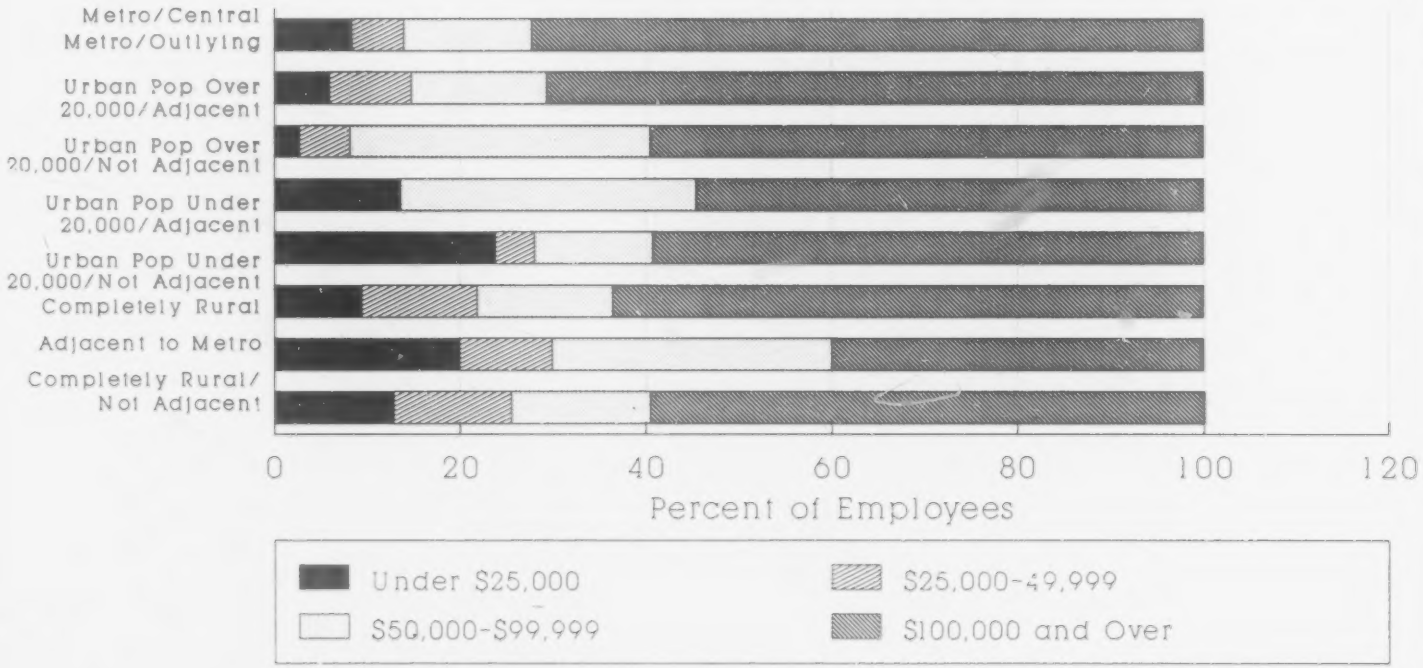


CHART 4.8
SIZE OF LOAN
BY TYPE OF COUNTY



metropolitan counties were used for modernization of plant or equipment, whereas a higher proportion of rural loans were used for equipment for startup and expansion. This may be due to the fact that a higher proportion of borrowers in urban areas are established firms (as opposed to startups). Alternatively, it may indicate that rural firms tend to engage in more mature types of manufacturing.

Development Impacts in Rural Communities

Job Creation and Retention

The CDBG job cost was substantially lower for firms operating in rural areas. The CDBG job cost two years after financing was $3,768 in nonmetropolitan counties compared to $5,786 in counties. This difference was even more pronounced when taking financial substitution into account: $4,721 vs. $7,890 (see Chart 4.9). In percentage terms, the CDBG job cost for firms in nonmetropolitan counties is 53 percent of the cost in metropolitan counties when not accounting for financial substitution. Taking substitution into account, this gap grows to 65 percent. This indicates that CDBG financing in rural areas was more cost effective and less likely to substitute for private financing than in urban areas.

Among nonmetropolitan counties, the lowest job cost was in counties with relatively high urban populations adjacent to metropolitan areas, while the highest job cost was in counties with relatively high urban populations not adjacent to areas (see Chart 4.10). In terms of economic base, two-year job cost was lowest in mining and manufacturing-dependent counties, and highest in government and retirement counties. This is likely to be associated with a higher emphasis on financing manufacturing firms in the former and on service firms in the latter. Manufacturing firms had a lower CDBG job cost than service firms (see Chart 4.11).

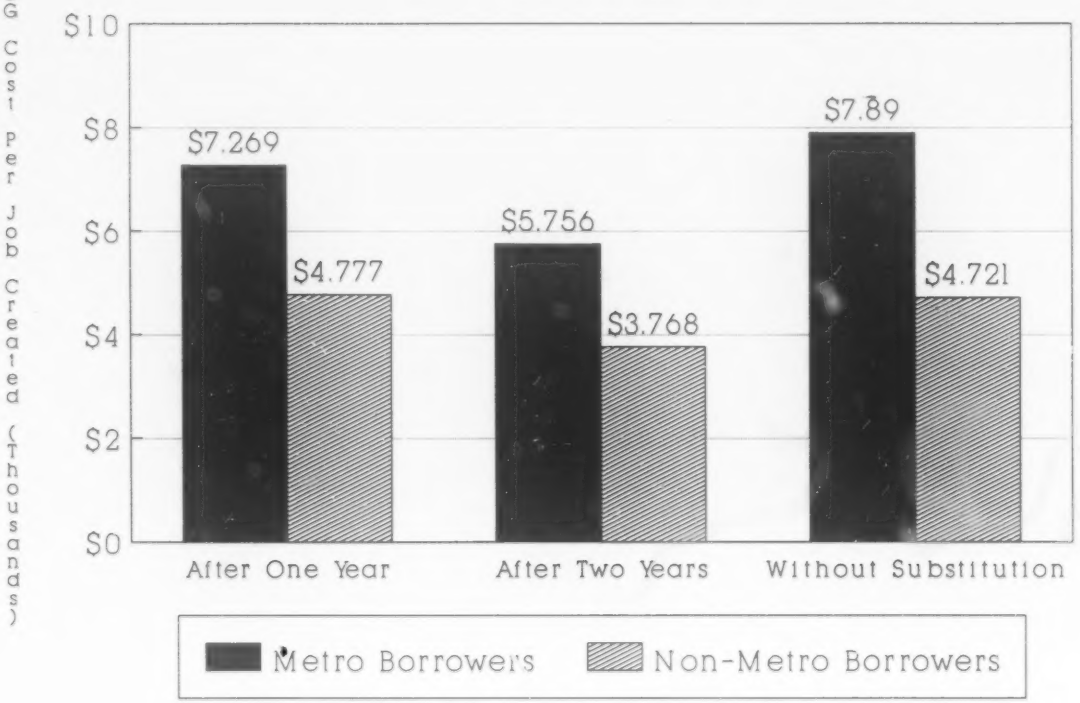
In addition to creating jobs more efficiently from the standpoint of CDBG investment, rural borrowers also were more likely to meet or exceed their initial job projections. As a whole, survey respondents from rural areas slightly exceeded projections while those from metropolitan counties fell somewhat short of job projections. This relationship held both for total jobs and for low/mod jobs. It should be noted that this comparison is only for those firms still remaining in business at the time of the survey.

Among firms whose investment decision was influenced by the availability of CDBG financing, rural borrowers indicated more frequently that they would have made the investment in another community or moved the firm to another community if the CDBG financing had not been available (16.9 percent vs. 12.2 percent). Non-rural firms were more likely than rural firms to have delayed or scaled-back the investment without the CDBG financing (see Chart 4.12). These differences were not statistically significant, however.

The survey does not indicate that rural borrowers were more dependent on CDBG financing than non-rural borrowers. Rural borrowers who sought private sector financing before approaching the CDBG financing source indicated slightly more frequently that they were able to obtain private financing on acceptable terms than non-rural borrowers. Rural borrowers also indicated slightly more frequently that they would have proceeded with the investment regardless of their abilityto obtain CDBG financing These differences were not statistically significant, however.

In terms of indirect economic impacts, rural borrowers are slightly more likely to produce trade goods than urban borrowers, although the difference is not statistically significant. Among nonmetropolitan counties, firms with the highest percentage of traded goods and services were in nonmetropolitan counties with small urban populations adjacent to areas. These are the fast growing "exurban" areas that attract firms out of central cities because of lower land costs and better access to interstate highways. Firms with the lowest percentage of traded goods and services were in completely rural counties adjacent to areas. These areas may not have the infrastructure needed to support business development, and thus have businesses which primarily serve the local population. Firms in rural areas not adjacent to areas also had a relatively low proportion of traded goods, although not as low as those in rural areas adjacent to areas.

CHART 4.9
CDBG COST PER JOB CREATED



Without Substitution= Job costs after two years excluding jobs which would have been created without CDBG loan and discounting jobs created for projects which would have been delayed or scaled back

CHART 4.10
JOB COST BY TYPE OF RURAL COUNTY

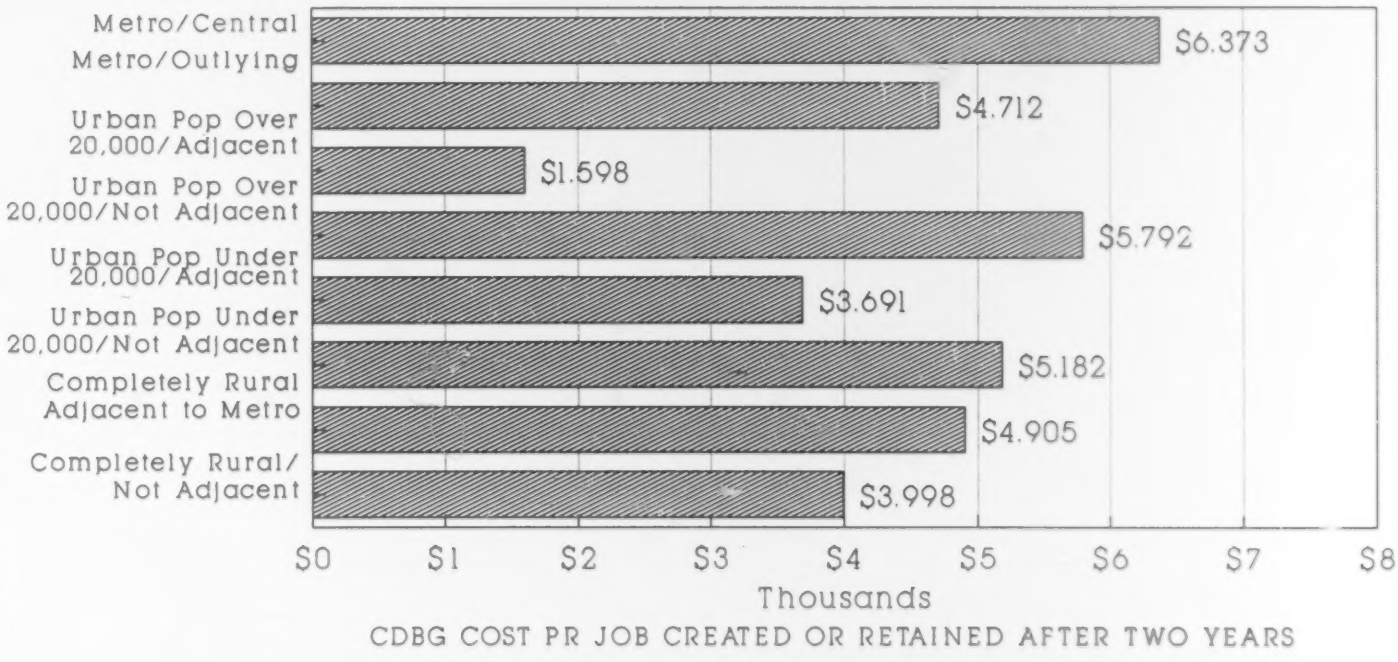
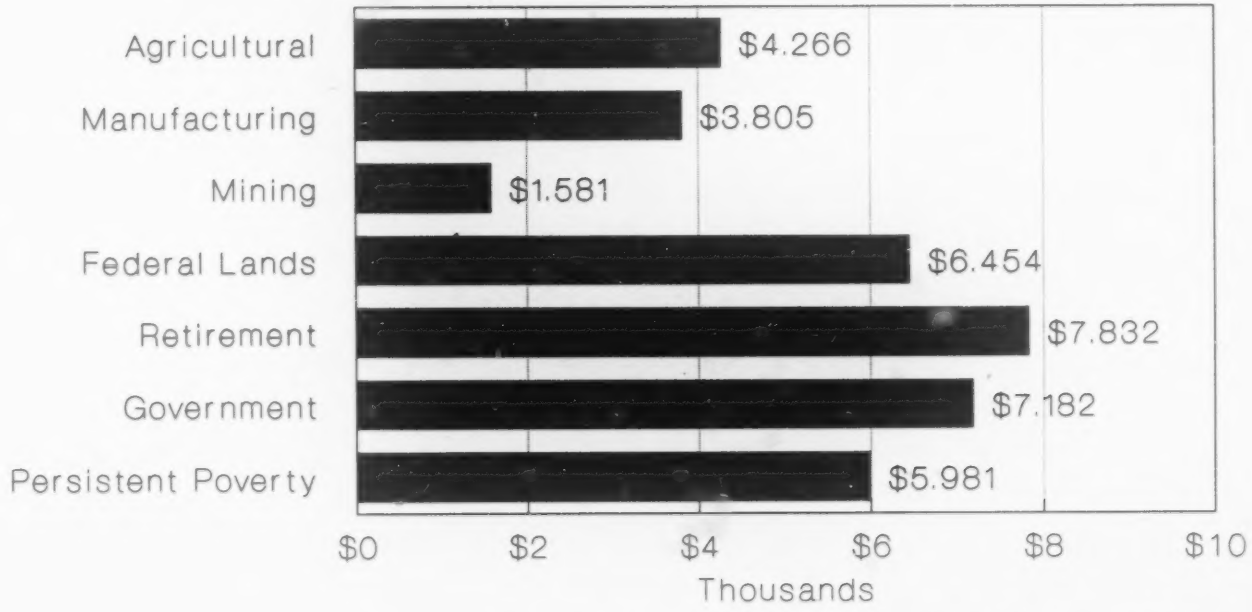
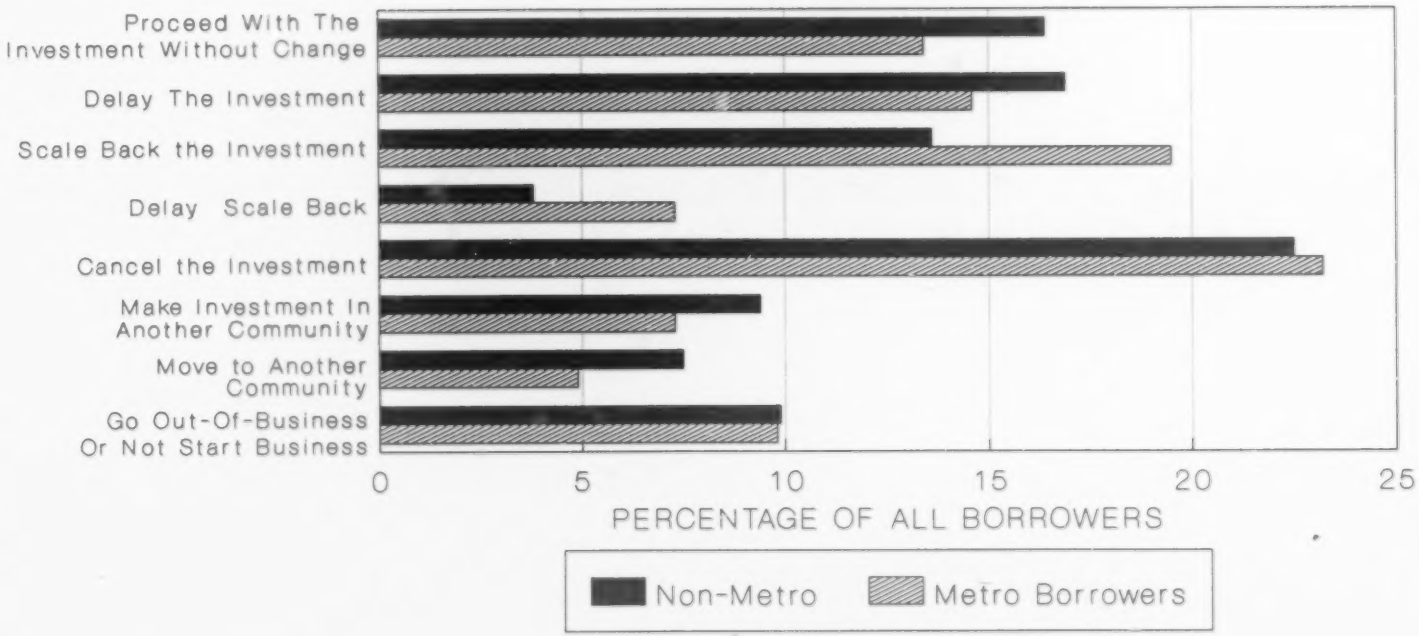


CHART 4.11
JOB COSTS IN COMMUNITIES WITH DIFFERENT ECONOMIC BASES



CLASSIFICATIONS DEVELOPED BY ROSS & GREEN,
U.S. Department of Agriculture

CHART 4.12
ACTION WITHOUT FINANCING BY TYPE OF COMMUNITY



Quality of Jobs Created and Retained

Jobs created and retained as a result of CDBG financing tended to be somewhat lower paying in rural areas. For the average firm in a rural area, almost 38 percent of the jobs paid $200 or less per week compared to an average of only 19 percent for firms in urban areas (see Chart 4.13). Firms in completely rural areas not adjacent to metropolitan areas had particularly low wage scales, with over 50 percent of the employees being paid under $200 a week (see Chart 4.14). Firms in rural areas were also slightly more likely to provide part-time or temporary employment than urban firms. On average, 13.5 percent of jobs in nonmetropolitan firms were part-time and 3.9 percent were temporary vs. 10.1 percent and 3 percent, respectively, for firms (see Chart 4.15). Firms in completely rural areas not adjacent to metropolitan areas provided a particularly high percentage of part-time and seasonal employment. Turnover rates in firms were lower in rural areas. This could indicate either greater job satisfaction or fewer job alternatives for rural workers.

The lower wages found in CDBG borrowers in rural communities reflect the generally lower wage scales found in such communities. An analysis of wage data in rural and urban communities by researcher Lucy Gorham found that while 33.6 percent of workers earned below $223 a week (the amount of weekly pay which would provide an individual with an annual wage of $11,611 - the poverty line) in metropolitan areas, close to 46 percent of workers in nonmetropolitan areas earned less than this amount. Given these statistics it is clear that the jobs created through the CDBG Program in rural communities, while not of high quality, were no worse than the average jobs being provided in these communities. The low wages in rural communities are tied to the types of firms being financed in these communities – more startups and smaller companies. As discussed in Chapter 5, these firms have lower quality jobs.

Targeting of Jobs

There does not seem to be any relationship between the proportion of low- and moderate-income workers hired by the firm and its location in a rural or metropolitan county – the proportion of low- and moderate-income hires was virtually the same in each category. Although the differences were not statistically significant, counties with urban populations or 20,000 or more not adjacent to metropolitan areas appeared to have the highest proportion of low- and moderate-income job creation (81.6 percent), while completely rural counties adjacent to metropolitan areas had the lowest proportion (72.8 percent).

A higher proportion of non-rural borrowers increased their use of employment and training resources "a lot," while a higher proportion of rural borrowers increased their use "a little." These differences were not statistically significant, however.

Economic Stability

There do not appear to be any significant differences in the stability of firms in rural and areas. About 72 percent of those companies still in business were in nonmetropolitan counties; while about 74 percent of those companies confirmed to be out of business or to have moved from the community were in nonmetropolitan counties. The difference is small in magnitude and was not found to be statistically different.

A comparison of the more detailed breakdown by type of county also revealed no pattern. The breakdown of companies still in business and those out of business or having moved in the eight county categories were almost identical, and any differences there were not found to be statistically significant.

Finally, the only significant difference found between those firms in business and those firms which were no longer operating in the community was in rural communities categorized as retirement counties. While only 12 percent of the operating firms were in these counties, almost one quarter of the out-of-business or relocating firms were found in counties classified by their large retirement population.

Conclusions

States clearly have begun to use the CDBG Program as an important tool in their efforts to strengthen rural economies. The use of CDBG

CHART 4.13
AVERAGE WEEKLY WAGES BY TYPE OF COUNTY

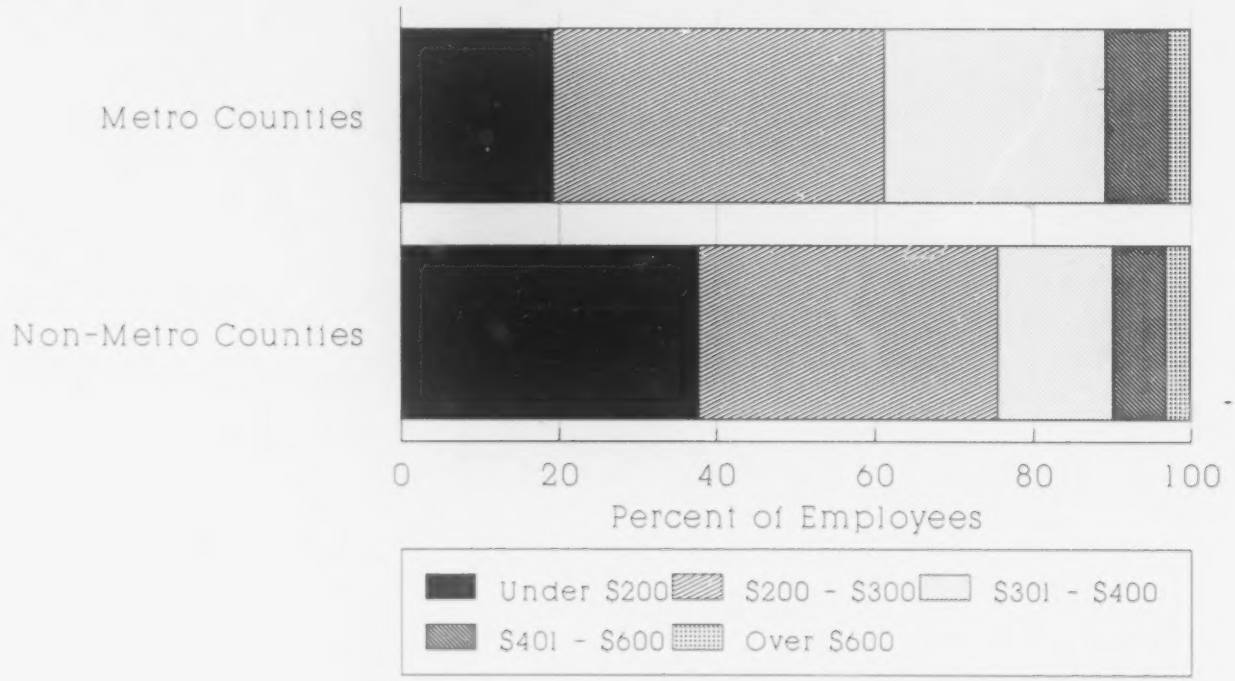
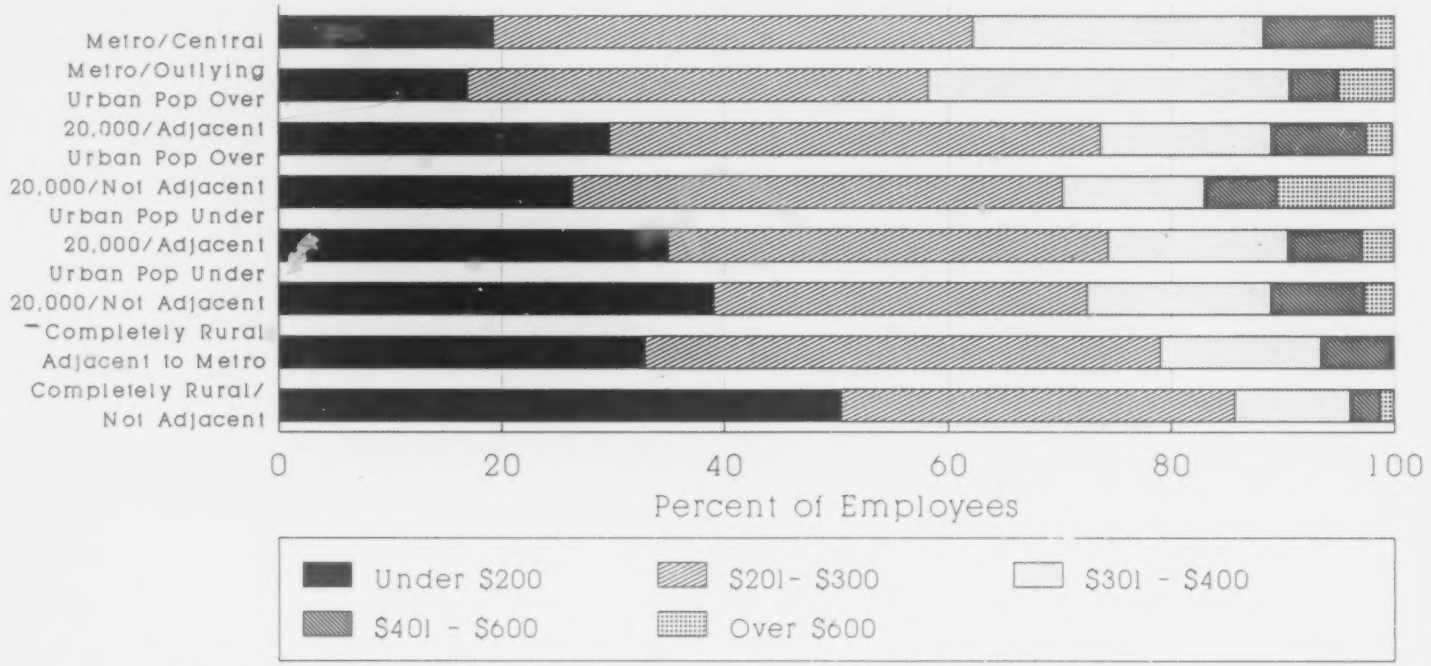


CHART 4.14
AVERAGE WEEKLY WAGES BY TYPE OF COUNTY



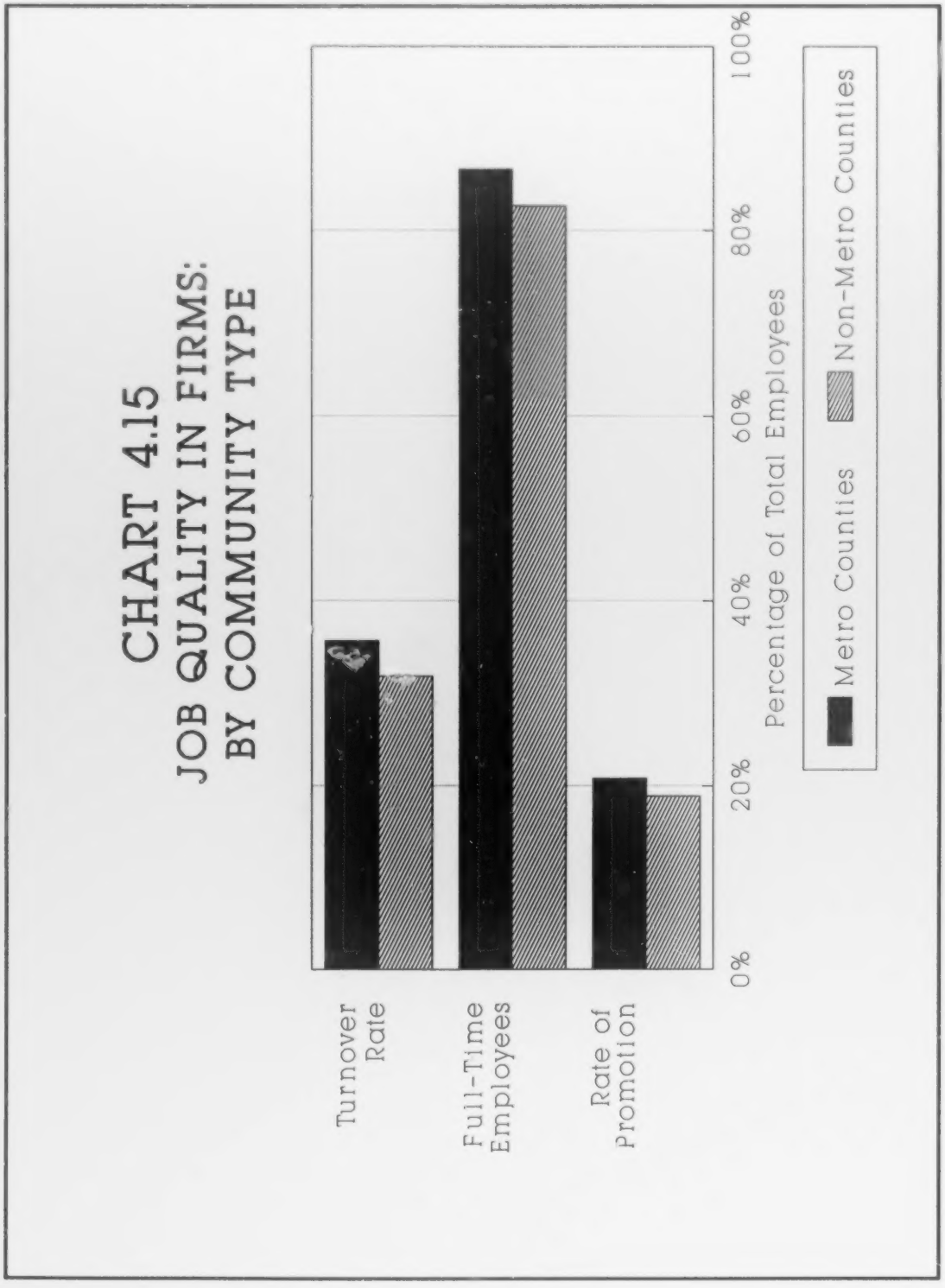


CHART 4.15
JOB QUALITY IN FIRMS:
BY COMMUNITY TYPE
Turnover Rate
Full-Time Employees
Rate of Promotion
0%
20%
40%
60%
80%
100%
Percentage of Total Employees
Metro Counties
Non-Metro Counties

funds for business lending is an increasingly important component of these efforts. Analysis of data on the CDBG Program provided by states, and the survey of businesses which have received CDBG financing, provide evidence not only of the importance of the program to rural communities but of the type of companies and activities supported in these communities.

While there were not significant differences between borrowers in metropolitan and nonmetropolitan counties, there was evidence that the firms financed through the CDBG Program in rural communities tended to be smaller, and were more likely to be startups. The reason for this difference is probably a reflection of existing structural differences in metropolitan and nonmetropolitan economies. Since more urbanized communities are more likely to have a larger, existing industrial base, the CDBG Program is used for industrial expansions and retentions. In many rural communities, particularly those historically dominated by agriculture and mining, the start-up of new enterprises provides one of the few avenues for business investment.

The experience of states in lending to firms in rural communities has some positive and some negative aspects. On the positive side, there is evidence from the borrower survey that investments in rural firms were more "efficient" in that they generated more jobs for each dollar investment of CDBG funds. Moreover, in nonmetropolitan counties, "real" job creation as reported by borrowers exceeds the anticipated job creation reported by states. On the negative side, it is clear that the quality of the jobs created in rural communities was considerably below that of the jobs in urban communities in terms of wages and the provision of primary employment opportunities (full-time, permanent jobs). While the higher proportion of low-wage jobs in firms financed in rural communities reflects the general wage scales in these communities, increased efforts could be made to improve the types of jobs being created in nonmetropolitan counties through the CDBG Program.

V. DEVELOPMENT IMPACTS BY BORROWER AND FINANCING CHARACTERISTICS

States often develop lending criteria for the use of their CDBG funds with limited information on the development impacts of different types of borrowers. For example, if the primary policy objective is to create quality jobs, then the focus of the CDBG business financing efforts should be on those types of companies which are most likely to have higher paying jobs and more permanent employment. Analysis of the job creation and retention impacts, targeting impacts and economic stability of various types of borrowers will assist states in developing policies for their CDBG financing efforts.

Job Creation and Retention

Various patterns were found in terms of the job creation and retention impacts of various types of loans. *First, smaller loans had greater job impacts for each dollar of CDBG funds expended.* Loans of between $25,000 and $49,999 had the lowest CDBG cost per job. When taking into account the impact of financial substitution, loans of under $25,000 had the lowest cost per job. Loans of over $100,000 had the highest cost per job, although when taking financial substitution into account, loans of between $50,000 and $99,999 had the highest job cost (see Chart 5.1).

CDBG job cost also varied by size of firm, but in the inverse direction of financing amount. Larger firms tended to have lower job costs. Firms with over 100 employees at the time of the financing had the lowest cost per job after two years, and firms with 50-99 employees had the second lowest. Firms with 10-19 employees had the highest cost per job. The one exception was that micro-businesses (less than ten employees) had a lower job cost than firms in the 20 to 49 and 59 to 99 employee categories (see Chart 5.2). When financial substitution is taken into account, the differences are even more dramatic.

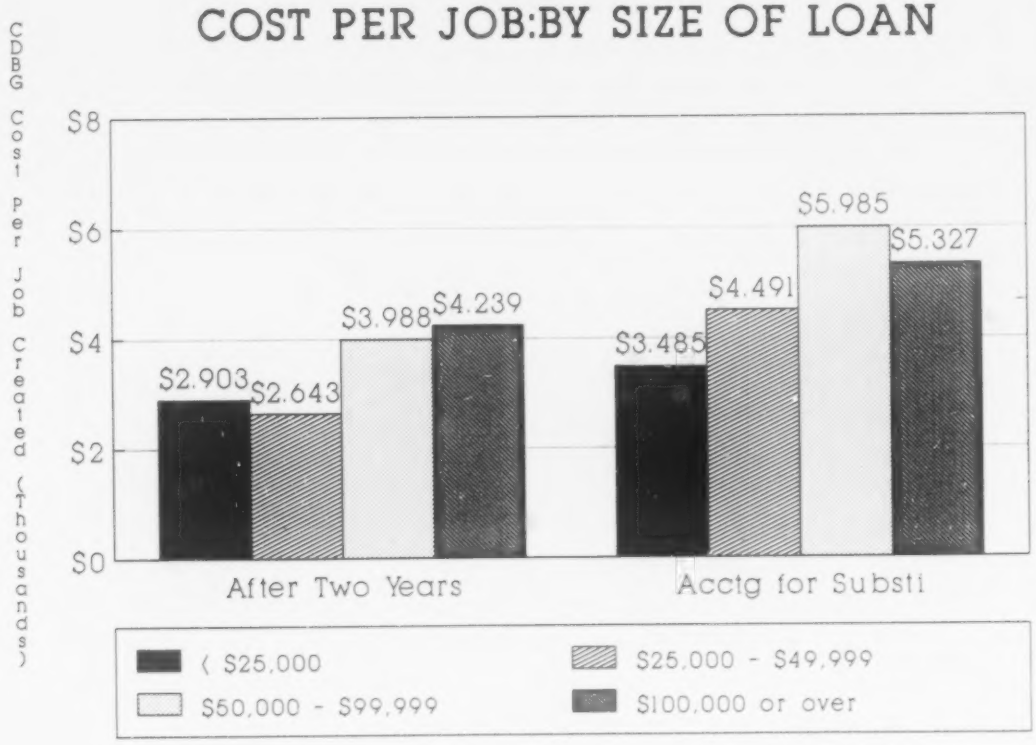
CDBG cost per job was also related to the type of investment financed by the CDBG loan. Firms that used financing to purchase equipment for startup or expansion, to acquire or expand a building, or for operating capital, had a relatively low job cost, while firms which used financing to replace equipment, often with more technologically advanced equipment, had a relatively high job cost. These relationships continued to hold after adjusting job costs for financial substitution effects. (Note: the number of cases is very low for the latter types of investment.)

An interesting shift in the relative job cost of the three types of uses identified as having low job costs occurs after adjusting for the effect of financial substitution. While financing for operating capital had the highest job cost of the three before adjusting for substitution, it had the lowest cost after the adjustment was made. This indicates that operating capital loans are the least likely of the three to substitute for private financing.

The type of investment financed by the CDBG loan was also related to the likelihood of a firm reaching its employment targets. Firms that used financing to purchase equipment for startup or expansion, to acquire or expand a building, or to modernize a building all exceeded their job projections. Those firms which used financing to replace equipment, often with more technologically advanced equipment, had lower actual than projected jobs. This may suggest that job projections for financings involving equipment replacement may be overstated to justify approval of CDBG financing.

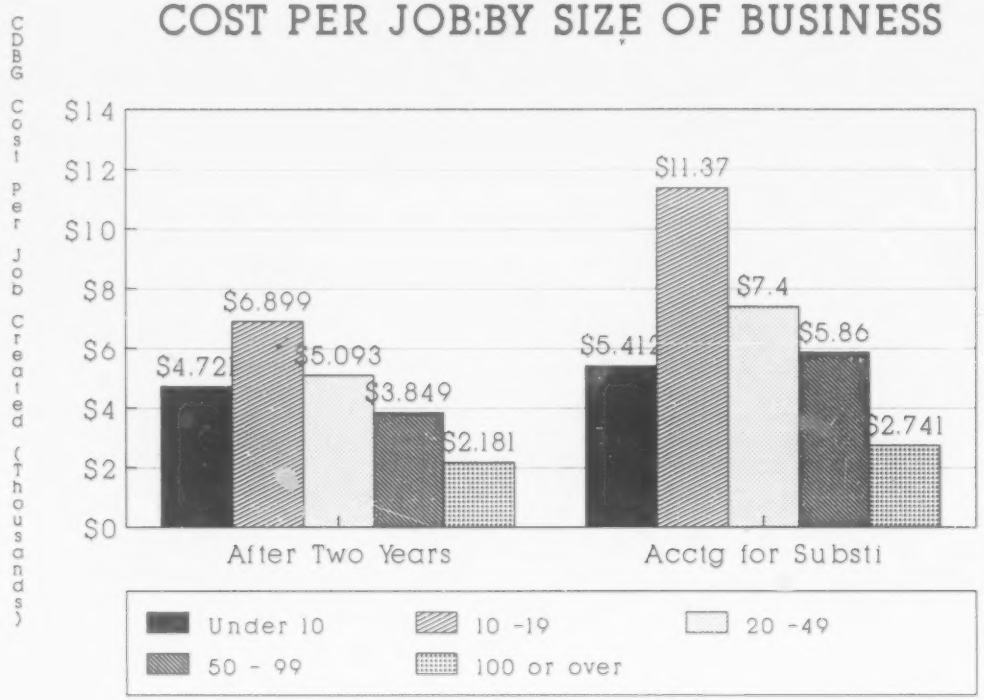
The CDBG cost per job created or retained also varied by the financial situation of the firm at the time of the financing. Those firms with operating losses and those that characterized themselves as startup companies expecting to become profitable after two or more years had the lowest job cost, while those that characterized themselves as established companies just breaking even or with a mix of profitable and unprofitable years had the highest job cost (see Chart 5.3). This indicates that the highest risk companies – retentions and risky startups – that stayed in business had the greatest job impacts for each dollar of CDBG funds loaned. The CDBG cost for each job created or retained in established firms with healthy profits, rose substantially when substitution effects were taken into account. While these firms appear to be "good investments" from a

CHART 5.1
COST PER JOB:BY SIZE OF LOAN



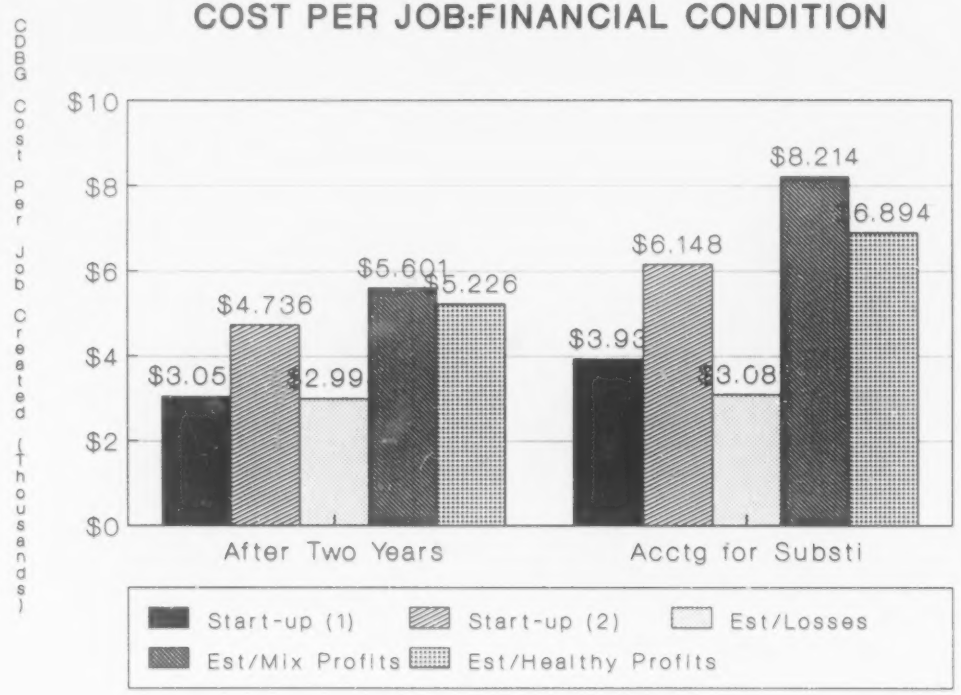
Acctg for Substi= Job costs after two years excluding jobs which would have been created without CDBG loan and discounting jobs created for projects which would have been delayed or scaled back

CHART 5.2
COST PER JOB:BY SIZE OF BUSINESS



Acctg for Substi= Job costs after two years excludin , jobs which would have been created without CDBG loan and discounting jobs created for projects which would have been delayed or scaled back

CHART 5.3
COST PER JOB:FINANCIAL CONDITION



Acctg for Substi= Job costs after two years excluding jobs which would have been created without CDBG loan and discounting jobs created for projects which would have been delayed or scaled back

Start-up (1) = Expecting to be profitable after 2 years
Start-up (2) = Expecting to be profitable within 2 years

public benefits point of view when financial substitution isn't considered, their true public benefits are considerably less since it appears that many of them could have obtained financing from conventional sources. If these companies increased their hiring of low- and moderate-income individuals as a result of receiving preferential CDBG financing, the issue of financial substitution becomes less relevant.

The analysis indicated that there was a relationship between the financial situation of the firm at the time of the CDBG loan and whether the firm met its initial job creation and retention projections. Startups expecting to become profitable after two or more years exceeded their initial job projections in the aggregate by a substantial margin. This was true for both all jobs and for low- and moderate-income jobs. However, since startups also had a higher failure rate this relationship is only true of startups that stayed in business. Established companies just breaking even or with a mix of profitable and unprofitable years, on the other hand, fell far short of their job projections

Loans to manufacturing firms had a lower two-year job cost than loans to firms in the service sector. Moreover, the CDBG job cost for branch plants or subsidiaries of firms headquartered elsewhere were substantially lower than for firms that were independent and locally-owned, both before and after adjusting for financial substitution (see Chart 5.4). This may be correlated with firm size.

The CDBG job cost for minority- and women-owned firms was substantially higher than the average. This difference in job cost may be due to the fact that these loans did not leverage as much private financing, and thus the CDBG funds made up the primary source of financing. The lower leveraging may be due to difficulties which women and minorities have in accessing conventional financing.

Quality of Jobs Created and Retained

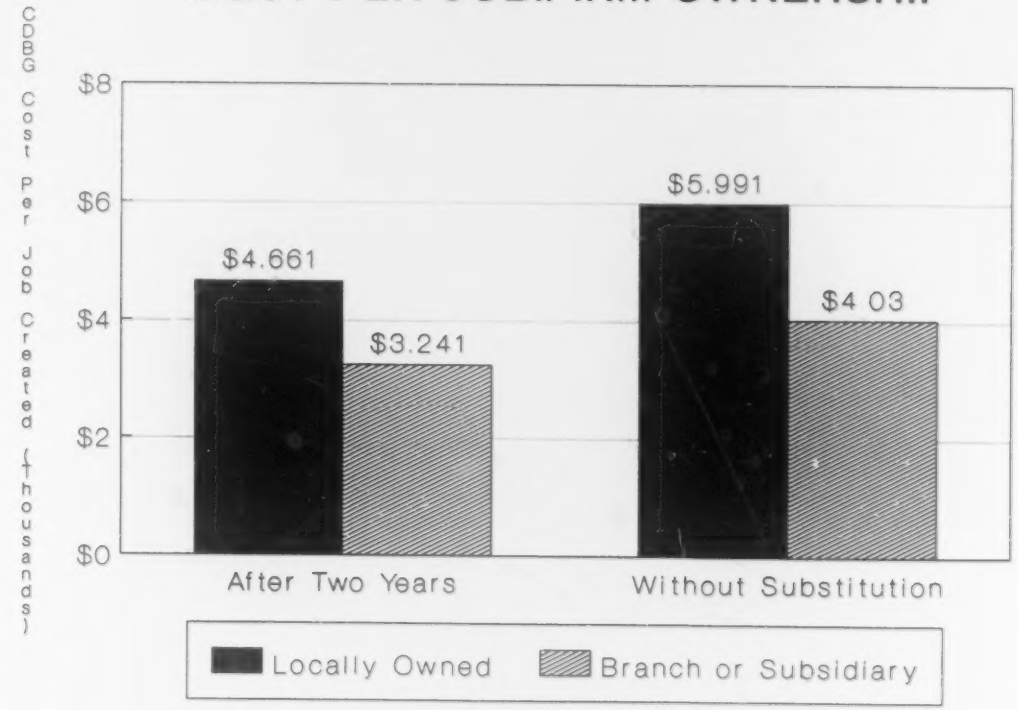
There were significant differences in the quality of jobs provided by CDBG recipients according to the type of borrower financing and the type of loan provided. *Branch plants and subsidiaries had significantly higher wages than independent and locally owned-firms.* On average, they had fewer than half the employees in the lowest wage category ($200 or less per week), greater than 50 percent more in the $301 to 400 per week range, and more than double the number in the $401 to 600 range (see Chart 5.5). These differences were statistically significant. Moreover, branch plants and subsidiaries had a significantly higher percentage of full-time employment than independent and locally-owned firms, almost 97 percent vs. 83 percent on average. Branch plants and subsidiaries also appeared to have a lower turnover rate, about 21 percent vs. about 36 percent annually, although this difference was not statistically significant. However, independent and locally-owned firms tended to promote a significantly higher proportion of employees, over 21 percent vs. less than 13 percent annually (see Chart 5.6).

Startup firms appeared to have higher turnover rates than established firms, although these differences were not statistically significant. Startups expecting to be profitable within two years had the lowest wages while established firms experiencing operating losses had the highest wages. Startups also had high turnover rates (see Chart 5.7 and Chart 5.8).

As would be expected, large differences were found in the quality of jobs in manufacturing firms and service firms. About 50 percent of all of the jobs in service firms paid less than $200 a week, a very low wage level by most standards (see Chart 5.9). Moreover, close to 30 percent of all workers in service companies were employed part-time and about 7 percent of the employees were temporary or seasonal workers. These figures were above those found in firms involved in manufacturing (see Chart 5.10).

Job quality also varied by business size. Firms with over 100 employees clearly offered the highest quality jobs in terms of wages and the percentage of workers who were employed full-time. Interestingly, it was the smaller firms which had a better record of promoting workers to better jobs in the firm (see Charts 5.11 and 5.12).

CHART 5.4
COST PER JOB:FIRM OWNERSHIP



Without Substitution= Job costs after two years excluding jobs which would have been created without CDBG loan and discounting jobs created for projects which would have been delayed or scaled back

CHART 5.5
AVERAGE WEEKLY WAGES BY FIRM OWNERSHIP

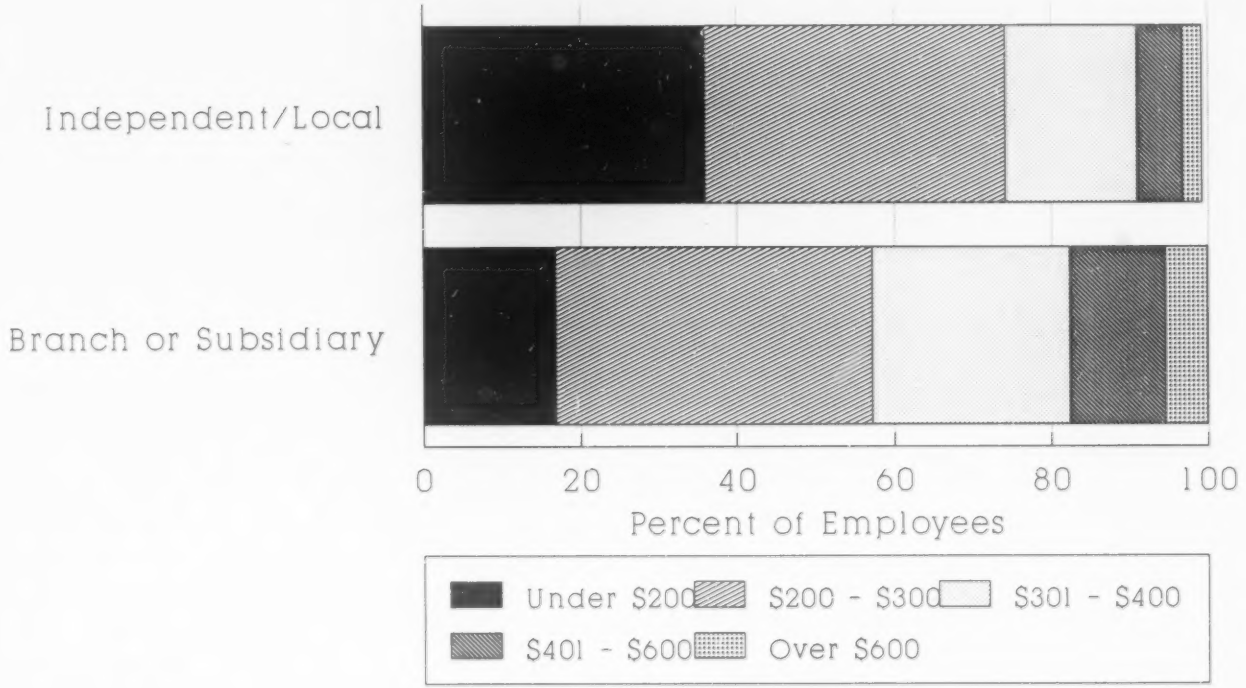


CHART 5.6
JOB QUALITY IN FIRMS: FIRM OWNERSHIP

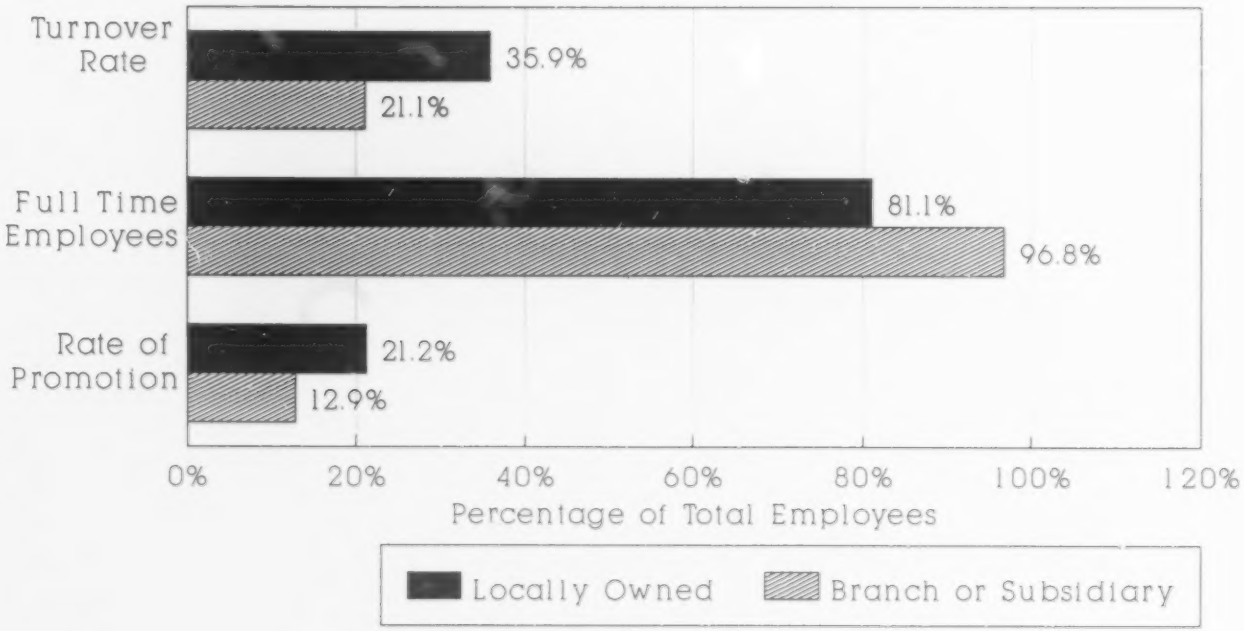


CHART 5.7
AVERAGE WEEKLY WAGES BY STAGE OF DEVELOPMENT

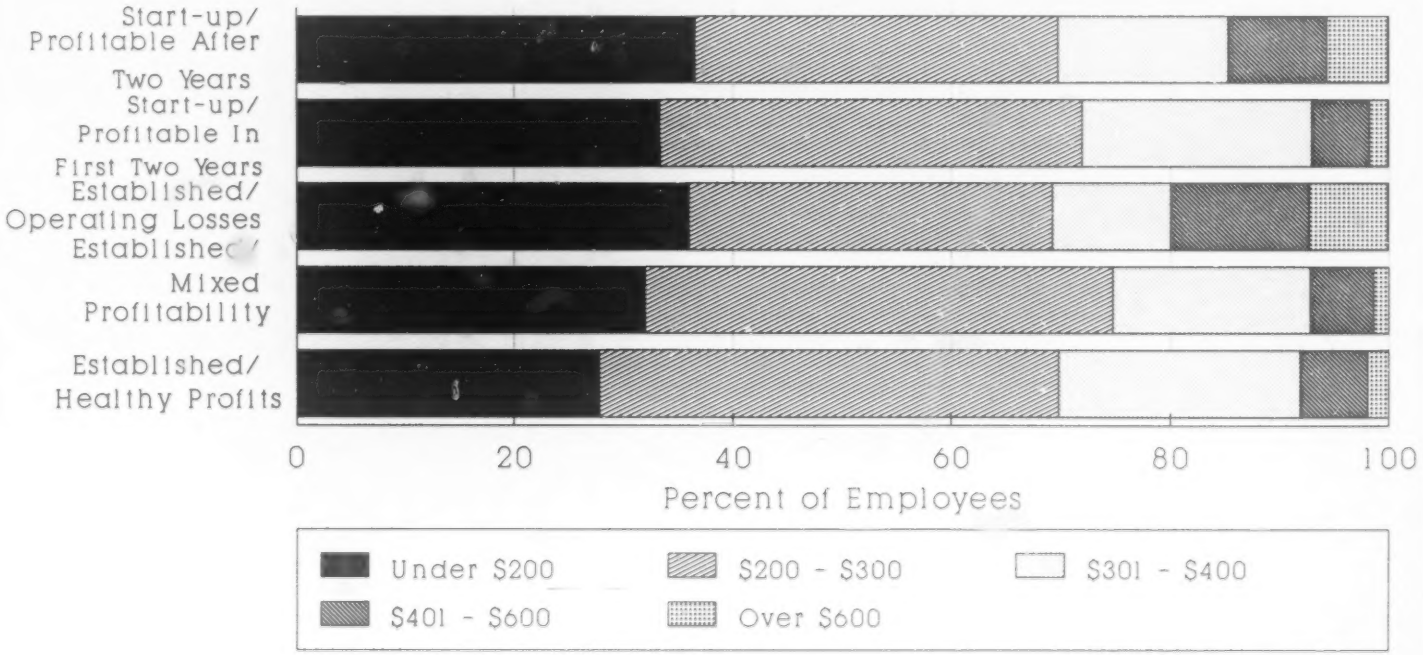
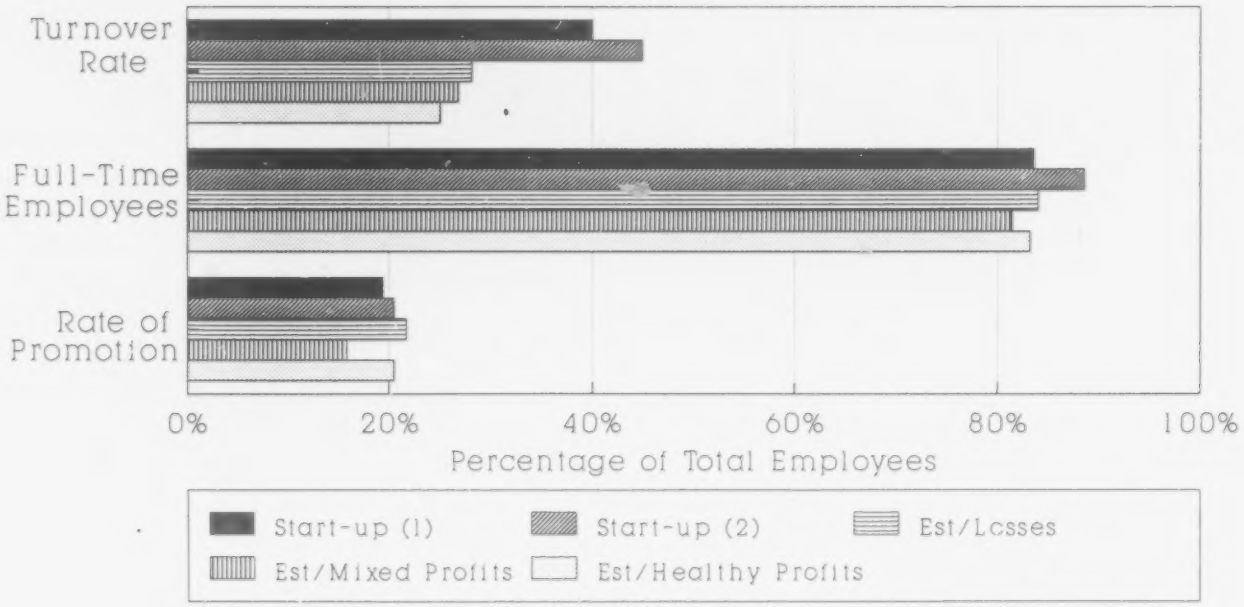


CHART 5.8
JOB QUALITY IN FIRMS: FINANCIAL CONDITION



Start-up (1) = Expecting to be profitable after 2 years
Start-up (2) = Expecting to be profitable in 2 years

CHART 5.9
AVERAGE WEEKLY WAGES BY SECTOR

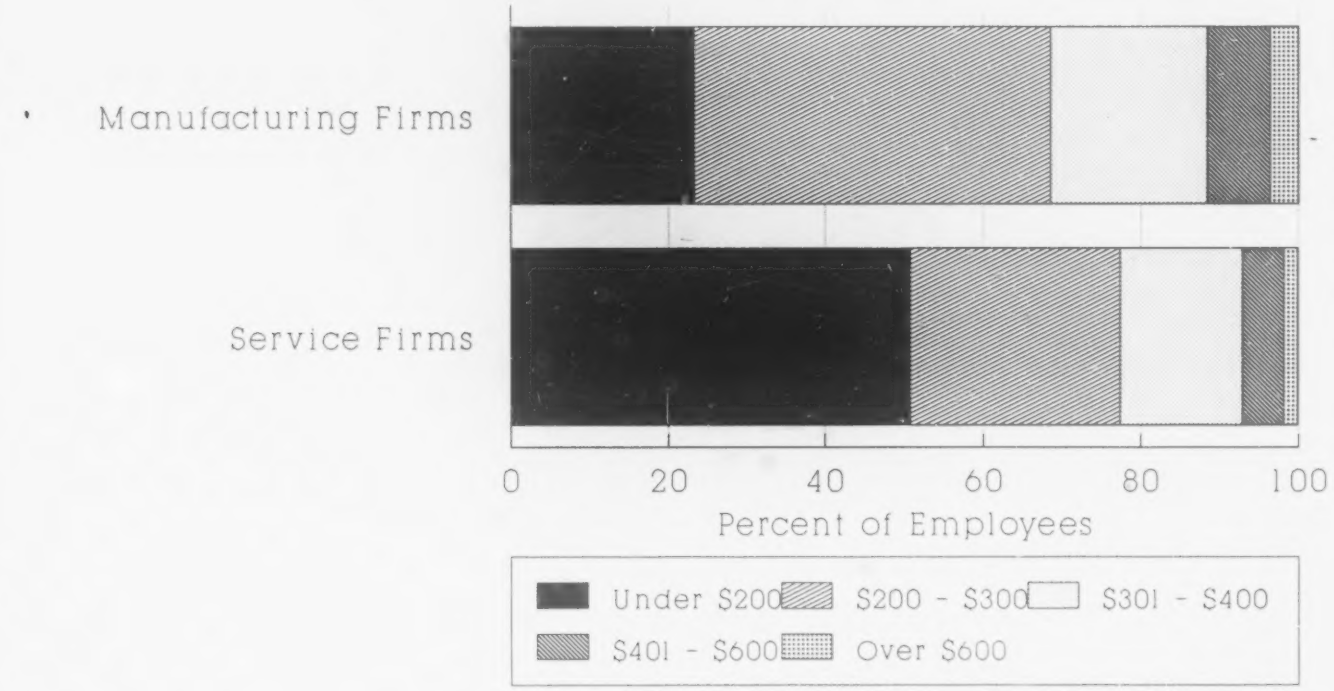


CHART 5.10
JOB QUALITY IN FIRMS: BY SECTOR

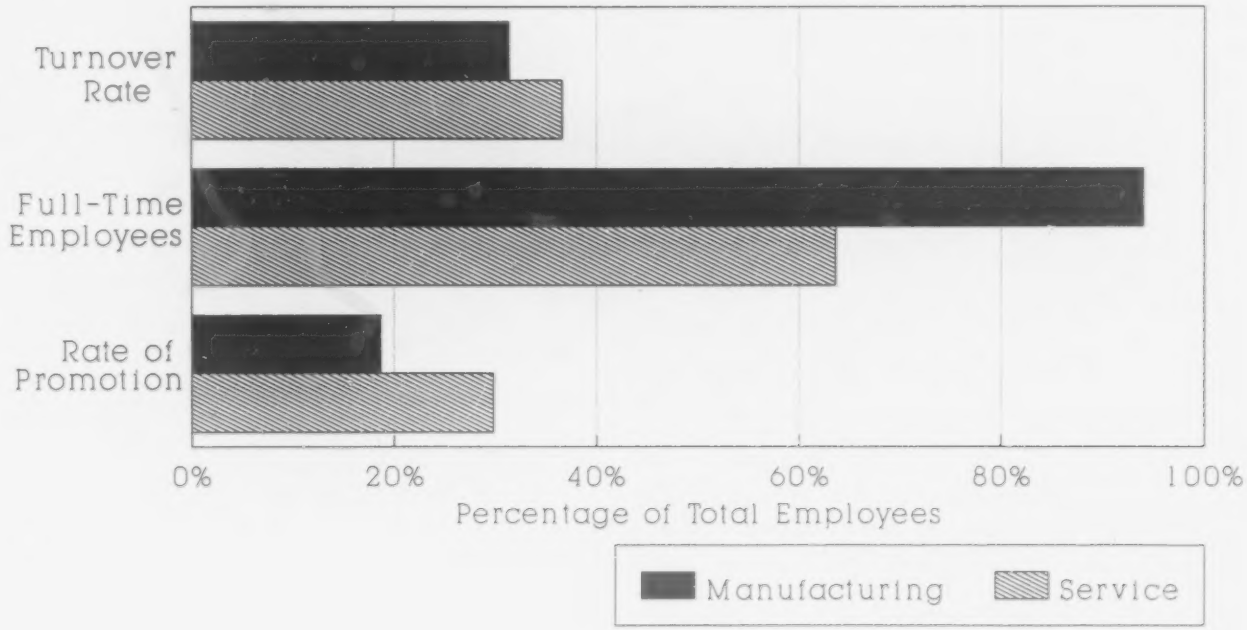


CHART 5.11
JOB QUALITY IN FIRMS: SIZE OF FIRM

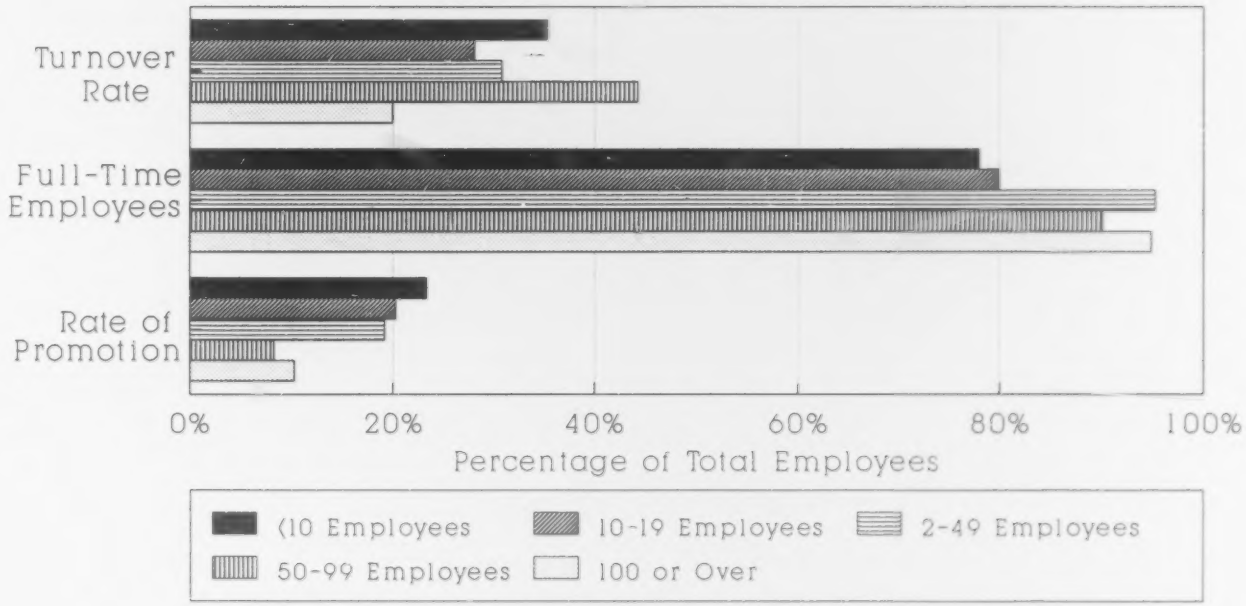


CHART 5.12
AVERAGE WEEKLY WAGES BY SIZE OF COMPANY

Targeting of Jobs

Some differences were found in the relationship between loan and borrower characteristics and the rate of low- and moderate-income job creation. *Independent and locally-owned firms appeared to provide a higher proportion of jobs to low- and moderate-income workers than branch plants or subsidiaries of firms headquartered outside the community.* However, this difference was not statistically significant. *Women- and minority-owned firms employed a higher proportion of low- and moderate-income workers than other firms.* However, these differences were also not statistically significant. *Significant differences were found in low- and moderate-income hires for firms of different sizes.* Firms with 50 - 99 employees and 10 - 19 employees had the highest low- and moderate-income hires, while the largest companies with over 100 employees had the lowest. *While service firms were found to hire a greater proportion of low- and moderate-income workers,* these differences were not found to be statistically significant (see Chart 5.13).

Economic Stability

Information on differences in economic stability by type of borrower was only available for the type of economic activity supported (i.e., startups, expansions, retentions), as defined in the survey to the states. This information does however reveal that startups were disproportionately represented in the companies which were confirmed to be out of business or having moved from the community. While only 19 percent of the companies still in business and operating in the community through which they received financing were start-ups, about 44 percent of the companies that were no longer operating in the communities through which they received the financing were defined as startups. Interestingly, companies classified as retentions, another category of high risk investment, accounted for 12 percent of the companies in business and only 8 percent of the companies which had gone out of business or moved.

Conclusion

The survey of firms which have received financing through the CDBG program provides evidence that the "development impacts" of investments in various types of firms differ. In many ways it is the highest-risk investments which have the highest pay-off in terms of public benefits. Startup firms and firms with operating losses – when they stayed in business – provided more jobs for each dollar of CDBG invested. Moreover, firms with operating losses (most likely to be "retention" efforts on the part of states) also provided the highest proportion of high wage jobs.

Another noteworthy finding from the survey was that firms with over 100 employees and branch plants and subsidiaries had both low CDBG costs for each job created or retained, and provided higher quality jobs in terms of wages and primary employment. These findings indicate that while a number of previous research studies suggest that small businesses might be the primary generators of jobs on an aggregate level, investments in very small firms are somewhat less "efficient" on the micro level, particularly when the quality of the jobs being created are taken into account. In addition, while it is clear that there are a number of reasons for a community to focus its economic development efforts on locally-based firms (evidence suggests that such firms provide more stable employment, that the owners are more committed to the community, and that the economic linkages with the community are stronger), in some communities, particularly those in non-metropolitan counties, investments in branch plants may still offer significant public benefits.

As would be expected, investments in firms in the manufacturing sector had a better public return in terms of lower costs for each job created or retained and higher quality jobs.

CHART 5.13
LOW AND MODERATE INCOME EMPLOYMENT

VI. CONCLUSIONS

The large volume of Small Cities CDBG funding expended on business financing clearly demonstrates that the CDBG Program has become a major national resource for promoting business activity and job creation targeted to the economically disadvantaged. Since a large portion of the non-entitlement areas served by the states are "rural" in nature, the program has become a significant resource for states in their efforts to revitalize rural economies. The preceding analysis, based on evidence provided from the states and from the firms which have received financing through the program, provides a comprehensive picture of how CDBG funds are being used to support business development activities.

Financing under the CDBG Program differs in some respects from other federal, state, and local financing programs. First, unlike many other programs, the primary objective of the CDBG Program is to benefit low- and moderate-income persons directly. While other programs presume that any job creation resulting from a business financing program will "trickle down" to improve the economic conditions of low- and moderate-income workers, the CDBG Program, alone, is explicit in requiring evidence that these individuals have benefited from the program. Second, the administration of the lending activities using CDBG funds is in many cases more complicated than standard public financing programs. The investment in a for-profit business is made by a state through a locality which applies in the name of the business. The payback from the loan can go either to the local community or back to the state. In any case, since local communities are the grantees for CDBG financing to businesses, responsibility for underwriting and monitoring of the investments is often complicated.

Business Financing through the CDBG Program: General Conclusions

The survey of borrowers and states provides evidence that for the most part, business lending activity supported through CDBG funds has met the program standards developed by HUD: borrowers report that well over 51 percent of the jobs created and retained are going to low- and moderate-income workers; in the aggregate, the jobs created or retained as a result of the program, as reported by the borrowers, match the anticipated job impacts reported by the states; about 28 percent of the current workers in firms receiving CDBG financing were hired through referrals from the state and local employment services or local employment and training programs; at least 50 percent of the borrowers increased their use of job training programs and public employment services after receiving CDBG financing; the CDBG funds were used to leverage a large amount of additional public and private sector financing; most companies receiving financing were unable to gain access to appropriate conventional financing; and the CDBG cost for each job created or retained was well within standards often used in the economic development field.

The data also suggest that the CDBG Program is being used to finance relatively high-risk firms which often face the most difficulty in accessing private financing. These include a large number of startups and established firms experiencing operating losses. Interestingly, while these investments had the highest failure rates, they also had the greatest payoff in terms of job impact for each dollar of CDBG invested.

To a large extent, the program was also used to invest in the type of firms which are most likely to have significant impacts on local economies. These include firms in the manufacturing sector and firms which export their goods and services outside of their immediate communities. Interestingly, about 25 percent of the firms interviewed reported that they exported goods and services outside of the U.S.

While the program has generally met its objectives, the analysis does identify some issues related to program performance. *One of the major issues arising from the analysis is the relatively low wages provided by firms receiving CDBG financing, particularly in the more rural communities.* To some extent, because of the emphasis of the program on hiring low- and moderate-income workers, one would expect that many of the jobs created or retained would not be of the highest quality in terms

of wages. However, hiring low- and moderate-income workers does not have to be equivalent to providing only low-wage, entry-level jobs. In operation, many states and local governments may not have made a clear enough distinction between the income of the person receiving the job and the wages being offered. Without more attention to job quality, the program may not be providing the kind of economic opportunities and benefits envisioned in the CDBG program. For example, on average, 33 percent of the jobs in the firms being financed paid less than $200 a week, or an annualized salary of only $10,400. This wage, though above the minimum wage at the time, is still not enough to allow a person to rise above the poverty line. In other words, the program may be creating jobs, but in many cases not providing low-income persons with the means to improve their lives in any significant way. Individuals may be simply going from the "poor" to the "working poor." More research is needed to assess whether the jobs created through the CDBG program provide a ladder to better paying jobs in the future. Such a study would require following the employment paths of low- and moderate-income individuals said to be benefiting from job creation through the program.

It is important to note that the period which was studied was one in which HUD allowed the wage levels of the jobs created or retained to serve as evidence of whether jobs were filled by low- and moderate-income individuals. This may account for the large number of low-wage jobs created. An analysis of firms financed since 1987, when HUD tightened their definition of what would qualify as evidence of benefiting low- and moderate-income workers, may prove that states have begun to look more critically at the issues of job quality. In any case, more analysis needs to be done on how the CDBG Program could be used to support job creation activities which provide real economic opportunities for low- and moderate-income people.

A second set of issues stems from how the CDBG Program is administered. As noted, the program funnels loans to a business indirectly, usually by providing grants to local governments which in turn make loans to businesses. The dual responsibility for the program results in inadequate attention to certain issues of importance in running a financing program. Since funding is to the locality, some states may not be as rigorous in their financial analysis of firms requesting CDBG financing as they might be for some of their other financing programs where funding goes directly to the business. Moreover, it is often the local government, with very limited staff capacity, which has responsibility for monitoring the investment. As a result, firms that are not economically viable are being financed, and problems in the portfolio are not recognized until it is too late to address them. The relatively large proportion of borrowers which were out of business at the time the survey was conducted indicates that more attention needs to be given to the viability of the firms being financed, and perhaps to the technical and managerial assistance needs of companies being assisted as well.

A third issue, which is also related to how the CDBG Program is administered, is that the program provides firms with very preferential financing, which may in some cases involved unnecessary subsidies. The interest rates charged to borrowers are substantially below the market rate, and often lower than those offered in other public financing programs. In addition to low rates, interest and principal deferrals and long loan terms are used to lower the payments made by businesses. While providing a capital subsidy to firms to encourage their investment or their hiring of low- and moderate-income workers may be necessary is some cases, the level of subsidy provided in many cases seemed high. Since the key goal of the CDBG Program is to assist low- and moderate-income residents, more analysis is needed to assess whether or not financing subsidies are changing the hiring behavior of firms, and what level of subsidy is required to affect firm hiring behavior.

The Importance of the CDBG Program in Rural Economic Development

Rural communities in the U.S. are very diverse in terms of their economic structures and economic performance. Some rural communities with an historic dependence on agriculture or natural resources have been devastated by economic changes and have experienced rapid outmigration and growing poverty rates. Other rural communities, attractive as retirement communities or as a base for manufacturing, have seen population growth and new economic activity tied to this growth. While

there are clear differences in the type of rural community, taken as a whole the economy of rural America has been plagued with many problems over the past decade. During most of the past decade, job growth was lower than in urban communities, poverty rates and unemployment were higher, and population losses were being experienced as residents moved from rural communities due to lack of economic opportunities.

In some rural communities the past few years have seen some important economic advances. A recent study by Leslie Whitener and Timothy Parker with the U.S. Department of Agriculture found that in 1988 for the first time, nonmetropolitan employment growth exceeded that of metropolitan areas. And, average annual unemployment in nonmetropolitan counties has declined from about the 11 percent range in 1982 and 1983 to about 6.9 percent in the first half of 1989 (*Rural Development Perspectives*, October 1989). This recovery, however, has been very uneven, with rural counties in many parts of the U.S. still reeling from declines in the agriculture and natural resource economies, and the movement of some of the more footloose manufacturing facilities to overseas locations.

The CDBG Program has provided states with an enormous resource for addressing the economic problems of rural communities. The use of these funds to provide financing to private business is a particularly important tool in a period of cutbacks in other federal programs which had formerly provided access to public financing to businesses in rural communities. While not solely used in nonmetropolitan areas, the analysis of business lending under the CDBG Program makes it clear that a large proportion of CDBG funds administrated by states are going to businesses in counties located in nonmetropolitan areas.

Comparisons between types of CDBG lending activity in rural and urban communities revealed some key differences. First, loans made in rural communities tended to be smaller and on more preferential terms. Second, a higher proportion of the loans in rural communities were used for startup companies. On many other measures – economic stability, ownership status, the proportion of manufacturing firms, and the proportion of low- and moderate-income individuals – there were few differences between those loans made in rural communities and those made in urban areas.

With regard to economic impacts, there are two findings of note with regard to urban-rural differences. First, the CDBG cost per job created or retained was lower in rural communities. Second, the quality of jobs created tended to be worse in the rural communities.

These findings yield some interesting inferences, although they must be considered speculative. It appears that states are willing to make riskier loans on more favorable terms in rural communities, perhaps reflecting the more dire economic circumstances faced by these areas. The lower quality of jobs created in rural areas may result from the same circumstance, although the generally lower wages found in rural communities may also be a large factor.

Policy Implications

In reviewing the use of the CDBG Program for financing for-profit businesses, it is critical to again go back to the intent of the program. Unlike most other public programs which provide financing to businesses, the major stated goal of the CDBG Program is to benefit low- and moderate-income individuals. This is an exemplary goal since many public financing programs lose sight of the link between a financing and its intended beneficiaries.

While this goal is exemplary, the question of whether CDBG financing activities are effectively meeting the goal or whether there are better ways than direct business financing of improving the linkage between CDBG expenditures and their intended beneficiaries must be raised. While the survey of borrowers of the CDBG Program provides evidence that funds are being used to create jobs for low- and moderate-income individuals, questions remain about the extent to which the program actually *changed* the hiring behavior of firms. In other words, was the proportion of low- and moderate-income workers on the payroll of a financing recipient different from what it would have been had another source of public or private financing been used? A related question involves whether the level of sub-

sidy provided to these companies was really necessary for achieving the intended public benefits as envisioned under the CDBG Program. Another related question is whether most states are making a clear distinction between their CDBG business financing and their other financing programs. In other words, is the linkage to job creation for low- and moderate-income individuals the prime concern of states in their use of the program, or are CDBG funds primarily being viewed by states as a more general resource for low-cost business financing?

While HUD has made a number of changes over the past few years to clarify the use of CDBG funds for business financing, efforts could be made to strengthen this area of activity *without making the program so inflexible as to not be useful to state and local governments.* For example: more explicit linkages between education and training and job creation could be encouraged; states could provide evidence that they have a specific strategy for the use of CDBG funds for business lending which differentiates its use from their other business financing programs; and the level of subsidy provided to businesses could be linked directly to the level of anticipated public benefits, and accountability mechanisms established (for example, tying the interest rate to the performance of the company in achieving its job creation goals and its targeting of jobs to low- and moderate-income employees).

With over $500 million being lent to private business in a five year period, the CDBG Program has become a significant source of federal funds for financing businesses to achieve specified public purposes. For many states, the CDBG Program has provided a substantial source of capital for business financing activity, particularly for reaching rural communities. It is timely to take a more in-depth look at the goals of the CDBG Program and how CDBG business lending fits within these goals.

APPENDIX

STUDY METHODOLOGY AND DATA COLLECTION PROCEDURES

A.1 Introduction

The research methodology consisted of five sequential steps: 1) development of research questions to be addressed by the survey; 2) definition of relevant economic development impacts of CDBG financings; 3) development of instruments to gather relevant data; 4) data collection; and 5) data analysis.

A.2 Developing Research Questions to be Addressed by the Survey

The major objectives of this and the other components of the CDBG study are, first, to document the extent and nature of the use of CDBG funds for rural economic development, and, second, to develop an understanding of how the program has affected rural economies. A subsidiary objective is to identify the circumstances under which the impacts of the program vary. It is hoped that this information will provide policy makers with useful guidance in the development of rural economic development programs. Five specific research questions were developed to be answered with information on the characteristics of financings, borrowers, and communities in which financings are made. The information was obtained from a borrower survey in conjunction with data already collected from state CDBG Program administrators in the first component of the study.

1) What are the characteristics of borrowers being served by the CDBG program? Borrower characteristics measured include industry, age, size, stage of development, geographic market, and location and social characteristics of firm owners.

2) What are the characteristics of the financings being provided? Financing characteristics measured include interest rate, maturity, lien position, use of funds, and deferrals on principal and interest.

3) What are the characteristics of communities in which financings are made? Community characteristics include extent of ruralness, composition of the local economic base, and income and employment levels.

4) What are the impacts of CDBG financing on rural economies? How effectively has CDBG financing spurred private investment? What has been the extent of job creation and retention? What proportion of jobs have gone to the rural poor? What has been the quality of the jobs created? How successfully have the private investments spurred by CDBG financing been sustained?

5) How have the impacts of CDBG financings differed in different types of communities and among different types of borrowers? What have been their relative effects in urban and rural communities; in different types of rural communities; in communities with different levels of economic distress? Have effects differed according to sector, stage of development, size, or ownership characteristics of borrowers; by amount and type of CDBG investment?

A.3 Defining the Economic Development Impacts of CDBG Financing

Because the primary mission of the CDBG Program is to promote local job creation and retention, particularly for the economically disadvantaged, it was decided that the jobs created and retained as a result of CDBG financings would be the central program impact to be measured. Measurement of job creation and retention involves three dimensions: *quantity* – the number of new or saved jobs, measured in relation to the dollar amount of CDBG financing; *quality* – wage levels, working conditions, advancement opportunities; and *distribution* – the recipients of jobs by economic group. Greatest emphasis was placed on the first dimension – number of jobs – reflecting both the widespread use of this measure to gauge the impact of economic development programs and the greater simplicity of quantitative measurement.

In measuring the job creation or retention impacts of CDBG financings, emphasis was placed on the importance of CDBG financing to the borrower's investment decision. The degree to which CDBG financing does or does not substitute for financing available in the private market can seriously alter estimates of job creation and retention impact. This is a factor frequently ignored in the impact evaluations of public development finance programs. Consequently, care was taken to find ways to estimate the likelihood that the business investment would not have taken place without the availability of CDBG funds, i.e., that the CDBG financing did not substitute for private sources of capital.

A second impact that was considered important was the success rate of firms receiving CDBG financing. Two measures were used to gauge the success rate of firms. The first was the current operating status of the firm (as of July 1989), i.e., whether the firm was still in business. The second was the current status of the loan i.e., whether the loan was current, delinquent, in default, or repaid. Firms that are able to repay their loans are likely to maintain higher employment levels in the long-run. Also, firms that repay their loans enable CDBG funds to be relent to other firms, which in turn can create additional jobs. Of course, the benefits of low default rates must be balanced against the program's goal of filling capital gaps and taking more risks than traditional sources of financing. States should not be too conservative or they will simply be substituting for available financing sources.

A third important impact was the extent to which the CDBG financing leveraged other investment in the community. This was measured by the amount of its own funds the firm receiving CDBG financing contributed to the investment, and by the amount of financing provided by private financial institutions.

A.4 Design of Data Collection

The purpose of the statistical analysis was to develop a profile of CDBG loans and to explore various questions about the relationships between financing impacts and the characteristics of CDBG financings, borrowers, and communities in which the financings were made. Data for the statistical analysis were obtained from three sources: 1) a telephone survey of a sample of CDBG borrowers; 2) loan data obtained from the survey of state CDBG administrators; 3) economic and demographic data for each county in which loans were made, obtained from the U.S. Department of Commerce Bureau of Economic Analysis and the U.S. Department of Labor Bureau of Labor Statistics. The second two data components had been collected during the first component of the CDBG study.

Characteristics of CDBG borrowers: These were obtained primarily from the borrower surveys. Surveying borrowers directly was considered preferable to use of state CDBG Program records because the required information involved details of the borrower's history, operations, and current financial condition that either were not in state records or not in an easily collectible form. Borrower characteristics obtained through the borrower surveys included: stage of development, current financial condition, financing history, age, products, location of ownership, social characteristics of ownership, and work force characteristics. Secondary data sources were used to obtain information on economic conditions in the borrower's immediate area.

Information on characteristics of CDBG financings: This was obtained primarily from the survey of state CDBG Program administrators. This included use of loan, size, interest rate, maturity, lien position, and whether the loan included principal or principal and interest deferrals. The state CDBG survey also provided information on the status of the loan. The borrower survey provided some additional information on financings. Borrowers were asked to indicate the relative attractiveness of different financing features. They were also asked to indicate what kinds of non-financial assistance they received.

Information on economic and demographic conditions: This was obtained from secondary data sources.

Job impacts: The borrower survey was central to data collection about the job impacts of CDBG financings. It was presumed that the borrower would have the most accurate information about employment levels before and after the CDBG

financing and on how the availability of CDBG financing affected the firm's investment decision. It was also presumed that obtaining this information from the borrower would introduce less bias into the estimates of job impact than using information supplied by state CDBG program administrators, the only other practical source of such information. While the borrower might have some incentive to overstate the impact of CDBG financing on its job levels in order to justify receipt of CDBG financing, his incentive may be less than that of the state CDBG program administrators.

Job creation impact was measured in two steps. First, an estimate of the jobs created or retained by the CDBG financing was derived. The borrower was asked to provide actual employment data at the time of receipt of the financing and at one- and two-year intervals after the financing. The borrower was then asked to estimate what its employment levels would have been at the same one- and two-year intervals had *no* financing been available through the CDBG program or any other sources it approached at the time. An estimate of the jobs created or retained was derived by subtracting the estimated from the actual figures for each time interval. Because level of impact was presumed to be closely related to the time interval since the borrower obtained and invested the funds provided by the CDBG Program, employment at standard time intervals (i.e., one year after financing, two years after financing) rather than as of actual dates were used to allow comparison of financing impacts. This measurement did not try to isolate the impact of the CDBG financing from that of any other participants in the financing. This was done for two reasons. First, borrowers have no accurate way of separating the job impact of the CDBG portion of the financing from that of the financing as a whole. Second, given this problem, it was presumed that the borrower's estimate of the CDBG financing's impact could be biased depending on the current status of its relationship with the local CDBG loan administrator since most borrowers understand that job creation or retention is an important factor on which CDBG program performance is evaluated.

Attribution of job creation or retention to the CDBG financing required a second set of questions to borrowers. The borrower was asked to describe what would have occurred had the CDBG funds *alone* not been available. The response to this question was used to adjust the job creation or retention estimates to account for the degree to which the CDBG financing substituted for other financing sources. This approach did not altogether eliminate the problem of respondent bias. However, it reduced the possibility by avoiding the more sensitive issue of number of jobs created or retained through the CDBG financing and also reduced the possibility that the borrower would provide an arbitrary response.

Job characteristics: The borrower survey was also used to obtain information about the characteristics of the jobs provided by CDBG borrowers, including various indicators of job quality such as wages, job duration (part-time/full-time, seasonal/permanent), turnover rate, and promotion rates. Information on the extent to which opportunities were provided to low- and moderate-income workers was also obtained, including percentage of jobs created that went to low- or moderate-income workers, and percentage of hires from employment and training programs.

Loan status and borrower's operating status: Data on loan status was obtained from the survey of state CDBG administrators. Data on borrower operating status was obtained in the course of conducting the survey. If borrowers did not have an active telephone number, their operating status was verified with either the state CDBG agency of the local CDBG program administrator.

A.5 Data Collection

Selection of Study Time Frame: It was decided that the time period for data collection should be as compact as possible without jeopardizing collection of sufficient data for the statistical analysis.

The period January 1, 1983 to December 31, 1985 was chosen as the time from for the study because it would permit estimates of employment impacts over a two-year period for all financings being studied but would also entail analysis of fairly recent experience, making accurate responses to survey questions more likely.

Selection of Borrower Sample: The pool of borrowers for the sample selection was obtained from the individual loan information forms submitted by state CDBG program administrators as part of the state survey. The borrower sample consisted of 715 borrowers who received loans from the CDBG Program during the study time period. This sample size was chosen in order to obtain approximately 400 completed surveys, which it was estimated would be necessary for the level of analysis contemplated. The response rate was estimated based on the experience with a similar previously conducted survey of firms receiving financing from U.S. Economic Development Administration-funded revolving loan funds.

Administration of Borrower Surveys: The borrower survey was administered by telephone. A telephone survey was selected over a mail survey in order to achieve a sufficiently high response rate. Both the length of the survey and the lack of an obvious incentive to respond indicated that a mail survey would probably have a very low response rate. In addition, certain questions were somewhat complicated and were likely to require explanation from the interviewer.

Borrowers were contacted using telephone numbers obtained from borrower information forms provided by state CDBG program administrators as part of the state survey. If the number listed on the form was wrong, disconnected, or not available through directory assistance, the state was recontacted in an attempt to obtain a valid number. The interviewers contacted the facility that received CDBG financing, which in some cases was the headquarters of the firm and in others a branch facility. The interviewer requested to speak to the head of the firm or, if he/she were not available, the manager of the facility. After reaching one of these individuals, the interviewer explained the sponsorship and purpose of the study, provided assurances of the confidentiality of all responses, and requested the firm's participation. If no one at that location could answer the questionnaire, the interviewer requested the name and telephone number of the president or another senior executive in the firm who could. At least five attempts were made to contact the president, plant manager, or another person with sufficient knowledge of the firm's operations and the circumstances surrounding the CDBG financing to answer the questionnaire before the borrower was considered a non-response.

During the course of the survey, 119 loans were removed from the sample for one of three reasons. The most frequent reason was insufficient information from the state CDBG Program administrator to contact the borrower. Seventy-nine loans more removed for this reason. Thirty-five loans were removed because they were actually other types of projects (e.g., real estate development, infrastructure) that had been incorrectly classified by states as business loans. Another four loans were removed because two borrowers had each received two loans in different years and there was no way to differentiate the individual impact of each loan. Finally, two other loans to a single borrower were consolidated into a single loan because they were made at the same time. This left a total of 596 firms to be surveyed.

Once surveys were completed, they were checked by project staff for completeness and consistency. Any problems were resolved through a follow-up telephone call.

Borrower interviews were conducted over approximately a three-month period (March - May, 1989). Of the 596 loans remaining in the sample, 299 surveys were completed (50 percent). Ninety-nine firms were confirmed to be out of business (16.6 percent). Three firms had moved to another community (.5 percent). One hundred fifty-seven firms refused to complete the survey (26.3 percent). Twenty-five firms had been sold and the new owners could not answer critical survey questions (4.2 percent). Finally, thirteen firms had not yet received the CDBG funds or had returned the funds without using them (2.2 percent).

In order to identify possible bias in the sample, a comparison was made between respondents and the universe of all borrowers between 1983 and 1986 included in the state survey. The results indicate that on a number of factors – type of community and type of economic development activity supported – the survey was very close to the distribution found in the population.

Because firms that had gone out of business or had been sold because of bankruptcy could not answer our surveys, the results of the survey tend to over-represent the characteristics of surviving firms. For example, because startup firms are more likely to fail, the survey results over represent the more established firms. This will tend to skew the borrower profiles toward established firms. It will also have the affect of understating the CDBG cost per job created and retained since a higher proportion of out of business firms than still-operating firms were non-respondents.

A.6 Preparation and Analysis of Statistical Data

Standard quality control procedures were used to ensure that responses were complete, legible and consistent, and that data were coded and keyed accurately.

Descriptive analysis was undertaken to obtain a profile of general characteristics of CDBG financings, borrowers, and communities in which loans were made, in order to examine interrelationships among these characteristics, and to explore how differences in these characteristics affected key measures of performance, including job creation and retention, business status, leveraging of private funds, and financial substitution. Tests for relationships included contingency tables with chi-square as a test of significance, and differences of means using t-values as a test of significance.

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